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A comparative study of the corporate bankruptcy reorganization law of the U.S. and China

Ren, Yongqing

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4 The plan-passing system

This chapter introduces the US and Chinese plan-passing system, analyzes the efficient and inefficient elements of both systems and provides reform suggestions for the Chinese plan-passing system.

4.1 The plan-passing system under US law

4.1.1 The classified voting system under US law

4.1.1.1 Overview of the classified voting

Under Chapter 11, a proposed plan should go through the voting and confirmation procedure in order to become effective. A proposed plan must designate all claims and interests, i.e. the claims held by creditors and interests held by shareholders, into different classes³³⁵ and specify the treatment of each class.³³⁶ A plan may put a claim or interest into a class only if it is substantially similar to the other claims or interests in that class.³³⁷ All claims or interests in a specific class should receive same treatment unless the holder of a particular claim or interest agrees to less favorable treatment.³³⁸ Under Chapter 11, all classes have the right to vote on the reorganization plan, except the classes that are unimpaired or the classes that will receive nothing under the reorganization plan. Unimpaired classes are deemed to have accepted the plan.³³⁹ Classes that will receive nothing under the plan are deemed to reject the plan.³⁴⁰

There are two circumstances in which a class of claims is unimpaired. First, the plan leaves the legal, equitable, and contractual rights to which the claim entitles its holder unaltered.³⁴¹

³³⁵ 11 U.S.C. §1123(a)(1).

³³⁶ 11 U.S.C. §1123(a)(2); (3).

³³⁷ 11 U.S.C. §1122(a).

³³⁸ 11 U.S.C. §1123(a)(4).

³³⁹ 11 U.S.C. §1126(f).

³⁴⁰ 11 U.S.C. §1126(g).

³⁴¹ 11 U.S.C. § 1124(1). Kenneth N. Klee suggested that the impairment test should not be applied to creditors' rights that have been altered by the operation of the Bankruptcy Code. The Bankruptcy Code clearly alters creditors' right from the moment the automatic stay takes effect. If the impairment test is applied absolutely to the creditors' pre-petition rights, the creditors' right will always be impaired. "The Code clearly alters a creditor's rights from the moment the automatic stay takes effect. Thus, the impairment test should be applied after Code driven alterations of rights to avoid the result that holders always have claims or interests in impaired classes for purposes of section 1124(1)."

Kenneth N. Klee (1994), The Concept of "Impairment" in Business Reorganizations, C946 ALI-ABA

Second, the plan may negate an acceleration clause (a clause that accelerates the payment of a claim after the occurrence of a default). In this situation, a claim is not impaired, if the plan reinstates the maturity of the claim as the maturity existed before the default without the approval of any other party, cures all the pre- and post-petition defaults,³⁴² compensates the holders of the claim for any damage incurred as a result of the reasonable reliance on the defaulted contractual provision, and does not otherwise alter the right of the holders of the claim.³⁴³ The essence of the definition of being unimpaired is to indicate under what conditions the contractual rights of claimholders are considered as not being materially affected.³⁴⁴ Putting a claim in an unimpaired class has great influence over the rights of the holder of the claim. If a class is unimpaired, it can not vote on the plan and is not entitled to the protection of the dissenting impaired classes provided in §1129(b). Pursuant to §1129(b), where a plan is to be crammed down over the objection of any impaired class, the plan must meet with the “non-discrimination test” and the “fair-and-equitable test” in order to ensure the protection of the interest of the dissenting impaired class.³⁴⁵ Klee commented that “[i]mpairment . . . determines which creditors or interest holders ought to have the right to vote to accept or reject a proposed plan. Those parties entitled to vote possess the leverage to bargain for favorable terms under a plan, and if negotiation reaches an impasse, they have the power to dissent from the unfavorable plan and thereby invoke the additional creditor protections set forth in section 1129(b).”³⁴⁶ By making a class unimpaired, the plan proponent actually excludes that class from participating in the negotiation and ratification of the plan and thus significantly influences the right that class may enjoy. The ability to make some claims unimpaired actually provides the plan proponent with an opportunity to decide whether to impair some claims and negotiate with the holders of these claims or to make these claims unimpaired and avoid negotiation with the holders of these claims.

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³⁴² 11 U.S.C. §1124(2)(A). It should be noted that the Code excuses the need to cure “a default which is a breach of a provision relating to -- the insolvency or financial condition of the debtor at any time before the closing of the case”. Kenneth N. Klee (1994), The Concept of "Impairment" in Business Reorganizations, C946 ALI-ABA 499.

³⁴³ 11 U.S.C. § 1124(2).

³⁴⁴ House Report, p.6364.

³⁴⁵ See Section 4.1.2.1 for detailed analysis of these two tests.

³⁴⁶ Kenneth N. Klee (1994), The Concept of "Impairment" in Business Reorganizations, C946 ALI-ABA 499.

A class of claims held by creditors accepts a plan, if at least two-thirds in amount (“the supermajority rule”) and more than one-half in number of the allowed claims of the class voted in favor of the plan.³⁴⁷ A class of equity interests held by shareholders accepts a plan, if at least two-thirds in amount (“the supermajority rule”) of the outstanding shares of the class voted in favor of the plan.³⁴⁸ After notice and hearing, the court may hold that a claimholder has not cast his vote in good faith or that a claimholder has not been solicited in good faith. In these events the vote will not be counted.³⁴⁹

4.1.1.2 The efficient elements of classification

Classification is a fundamental element of the collective procedure. According to the creditors’ bargain theory, bankruptcy law should respect the interested parties’ non-bankruptcy entitlements. Classification is efficient in that it respects the interested parties’ non-bankruptcy entitlements by grouping claims that are substantially similar according to their nature as defined under non-bankruptcy law³⁵⁰ into one class and by treating these claims equally. The equal treatment of claims that are substantially similar in nature under non-bankruptcy law respects the parties’ non-bankruptcy entitlements, constrains unfair discrimination to substantially similar claims.³⁵¹ Without classification, similar claims may receive discriminative distribution, which may cause forum shopping and strategic bargaining behavior. For instance, in the absence of equal treatment of substantially similar claims, parties who can get favorable treatment may choose a reorganization procedure even if it is not good for the collective parties as a whole and the parties holding substantially similar claims will not act as a group but struggle for individual advantage. Therefore, judged against the creditors’ bargain theory, classification is efficient because it respects the

³⁴⁷ 11 U.S.C. §1126(c).

³⁴⁸ 11 U.S.C. §1126(d).

³⁴⁹ 11 U.S.C. §1126(e). A vote should be disqualified if it was cast for the ulterior purpose of securing some advantage to the voting party. In re Lloyd McKee Motors, Inc., 157 B.R. 487, 489 (Bankr. D. N.M. 1993). Absent an ulterior purpose, such as malice, black mail, or the intent to destroy the debtor, the vote should be counted. In re Federal Support Co., 859 F.2d 17, 19 (4th Cir. 1988); In re Peter Thompson Assocs., Inc., 155 B.R. 20, 22 (Bankr. D. N.H. 1993).

³⁵⁰ For instance, general unsecured creditors are substantially similar to each other and are substantially different from subordinated unsecured creditors according to their contracts with the debtor and contract law.

³⁵¹ Douglas G. Baird, *ELEMENTS OF BANKRUPTCY*, Foundation Press, 4th edition, 261-2 (2006) (Commenting that classifying similar claims into one class and providing the same treatment to similar claims is a practical way of counteracting unfair discrimination or unfair treatment of similar claims).

interested parties' non-bankruptcy entitlements and hinders the plan-proponent from providing discriminative distribution to substantially similar claims.

Moreover, according to the creditors' bargain theory, an efficient bankruptcy system mimics the result of a hypothetical bargain. In the hypothetical bargain, interested parties would agree to replace the individual debt-collection system with a collective procedure in which interested parties holding substantially similar claims will be put into one class and receive a pro rata distribution, so that all the interested parties can realize a structured debt-collection and avoid the uncertainty and cost under the individual debt-collection system.³⁵²

Classification is an important element of bankruptcy law that mimics the hypothetical bargaining result. Classification is efficient in that classification helps the interested parties to achieve a structured collective debt-collection procedure while at least respecting the non-bankruptcy entitlements with a view to maximizing the debtor's overall value while minimizing the debt-collection cost. In addition to the efficient elements of classification, limiting strategic behavior, discussed in the preceding paragraph, classification helps to enhance interested parties' bargaining efficiency and minimize the bargaining cost because it provides the foundation on which the holders of similar claims can bargain as a collective and for the application of a majority voting rule. Classification fosters reorganization bargaining in that holders of similar claims may bargain as a collective. By classification, claimholders who hold substantially similar claims are put into one class and may bargain as a collective. Classification channels the bargaining among many individual claimholders into bargaining among several classes and reduces the cost of the bargaining among all the individuals, makes the bargaining proceed in a more structured and manageable way. Based on classification, members of a class may bargain as a collective and bargain through some capable representatives, such as several powerful members of the class and/or the professional agents employed by the class and bargaining efficiency is enhanced by bargaining through capable representatives.³⁵³ In addition, classification fosters reorganization bargaining in that it

³⁵² Thomas H. Jackson (1982), *Bankruptcy, Non-Bankruptcy Entitlement, and the Creditors' Bargain*, 91 *Yale L. J.* 857, pp. 860-4.

³⁵³ W. Christopher Frost (1992), *Running the Asylum: Governance Problems in Bankruptcy Reorganizations*, 34 *Ariz. L. Rev.* 89, p. 116 (talking about the difficulty in direct involvement of individuals and the need of representation. The need of representation implies the importance of classification, since classification provides the basis for representation); Douglas G. Baird and Robert K.

provides the basis for the majority voting rule for class voting, which fosters the bargaining efficiency by allowing the opinion of a suitable majority to bind the objecting minority of one class.

To conclude, against the standard established by the creditors' bargaining theory, classification is efficient in that it helps to reach maximum respect of the interested parties' non-bankruptcy entitlements in the collective debt-collection proceeding, restrains discriminative distribution and strategic behaviors, fosters decision-making efficiency, and helps to minimize bargaining cost.

4.1.1.3 The inefficient elements of classification

The inefficient elements of the US classification system mainly lie in that it provides room for "gerrymandering" or "vote manipulation". The ability to mold classes is powerful and has great impact over the distribution of the debtor's value and the confirmation of a plan. It is often not easy to decide whether some claims in a specific case are substantially similar for the purpose of classification. For example, it is unclear whether the unsecured claims held by tort creditors, employees, loan creditors or trade creditors in a specific case are substantially similar to each other and should be put into one class.³⁵⁴ What makes the situation even more complicated is that Chapter 11 does not mandate that similar claims must be classified into one class.³⁵⁵ Generally courts hold that separate classification and disparate treatment of similar claims are permissible when the disparate treatment does not constitute unfair discrimination.³⁵⁶

Rasmussen (2001), Control Rights, Priority Rights and the Conceptual Foundations of Corporate Reorganization, 87 Va. L. Rev. 921, pp. 930-1 (describing the early history of bankruptcy reorganization, during which the individual claimholders were classified and bargained through the representative of different classes, whom comprised the reorganization committee that dedicated to bargaining and drafting the reorganization plan. This classified bargaining and voting is further codified and inherited by the current US bankruptcy code. The development history of the US code demonstrates the contribution of classification to decision-making efficiency in reorganization context).

³⁵⁴ Douglas G. Baird, *ELEMENTS OF BANKRUPTCY*, Foundation Press, 4th edition, 260 (2006)..

³⁵⁵ 11 U.S.C. § 1122(a) only provides that claims being put into one class should be substantially similar and does not provide that similar claims must be put into one class. See e.g., Scott F. Norberg (1995), Classification of Claims Under Chapter 11 of the Bankruptcy Code: The Fallacy of Interest Based Classification, 69 Am. Bankr. L. J. 119, pp. 145-6. Bruce A. Markell (1995), Clueless on Classification: Toward Removing Artificial Limits on Chapter 11 Claim Classification, 11 Bankr. Dev. J. 1, p. 34 ("Section 1122(a) addresses only improper combinations of claims, not allegedly improper segregation. It is silent on what claims "must" be classified together..").

³⁵⁶ See e.g., *Frito-Lay, Inc. v. LTV Corp. (In re Chateaugay Corp.)*, 10 F.3d 944, 957 (2d Cir.1993) (holding that separate classification and disparate treatment had rational basis); *Jersey City Medical*

The problem of gerrymandering is especially prominent in the context of cram down. The precondition for the debtor to cram down its plan is that the plan has gained the acceptance of one impaired class. This requirement is an important threshold for cram down since it helps to ensure some baseline protection of the interest of the impaired classes and restraint over the quality of the plan by forcing the debtor to try to negotiate with impaired classes and achieve some basic agreement in this negotiation.³⁵⁷ In practice, the debtor may try to satisfy this requirement by manipulating the classification. One method is artificial separation of similar claims, i.e. getting a friendly accepting impaired class by separating hostile claimholders from friendly ones so that the friendly claimholders will constitute the requisite majority of a voting class.³⁵⁸ Another method is artificial impairment, i.e. creating an accepting impaired

Ctr., 817 F.2d at 1061 (court “immediately note[d] the reasonableness of distinguishing the claims of physicians, medical malpractice victims, employee benefit plan participants, and trade creditors,” and approved the different treatment of the different classes); *In re 11,111, Inc.*, 117 B.R. 471, 477-78 (Bankr. D.Minn. 1990) (approving separate classification and preferred treatment of noninsider claims); *Olympia & York Florida Equity Corp. v. Bank of New York (In re Holywell Corp.)*, 913 F.2d 873, 880 (11th Cir.1990) (disapproving separate classification and unfair discriminatory treatment of the different classes, while recognizing that the Code permits fair discrimination); *In re Pine Lake Village Apartment Co.*, 19 B.R. 819, 831 (Bankr. S.D.N.Y. 1982) (the court rejected the separate classification on the basis of unfair discrimination reflected in the different treatment for the classes of similar claims).

³⁵⁷ J. Ronald Trost, Joel G. Samuels, and Lantry Kevin T. (1998), *Survey of the New Value Exception to the Absolute Priority Rule and the Preliminary Problem of Classification*, SD24 ALI-ABA 401, p. 416. Peter E. Meltzer (1992), *Disenfranchising the Dissenting Creditor through Artificial Classification or Artificial Impairment*, 66 Am. Bankr. L. J. 281, p. 302.

³⁵⁸ E.g., *In re Pine Lake Village Apartment Co.*, 19 B.R. 819, 831 (Bankr. S.D.N.Y. 1982) (the court held that “The debtor may not ignore the rejection of its plan by the holder of a large unsecured deficiency claim simply because the debtor designated a specially preferred separate class of easily created trade creditors whose acceptances may be readily obtainable by offering them more than the disfavored deficiency claim holder. Manifestly such treatment of unsecured claims is unfairly discriminatory within the meaning of 11 U.S.C. § 1129(b)(1).”). *In re U.S. Truck Co.*, 800 F.2d 581, 586 (6th Cir. 1986) (the court permitted the union committee to be placed in a class separate from other impaired creditors on the ground that the union committee had a noncreditor interest—e.g. rejection of the reorganization plan will benefit its members in the ongoing employing relationship and that to allow the union committee to vote with the other unsecured creditors would be to allow it to prevent a court from considering of a plan that a significant group of creditors with similar interests have accepted. However, the court pointed out that “We agree . . . that there must be some limit on a debtor’s power to classify creditors in such a manner. The potential for abuse would be significant otherwise. Unless there is some requirement of keeping similar claims together, nothing would stand in the way of a debtor seeking a few impaired creditors (or even one such creditor) who will vote for the plan and placing them in their own class.”). *In re Club Associates*, 107 B.R. 385, 401 (Bankr. N.D. Ga. 1989) (the court permitted the classification which separated the under-secured claim of a very big sum from the general unsecured claim of a small sum. Some scholars commented that this kind of classification might lead to the absurd fact that the debtor could ignore the unsecured claim (deficiency claim) of about \$4 million through providing grand distribution to and getting acceptance from the holders of the unsecured claim (trade claim) of about \$10,000). Peter E. Meltzer (1992), *Disenfranchising the Dissenting Creditor through Artificial Classification or Artificial Impairment*, 66 Am. Bankr. L. J. 281, p. 302.) J. Ronald Trost, Joel G. Samuels, and Lantry Kevin T. (1998), *Survey of the New Value Exception to the Absolute Priority Rule and the Preliminary Problem of Classification*, SD24 ALI-ABA 401, pp. 411-22.

class by artificially slightly impairing the interests of a friendly class.³⁵⁹

The court may play a role in counteracting the problem of classification manipulation. It is suggested that where there is suspected manipulation of classification, the court can solve the problem by ordering the debtor to put all the substantially similar claims into one class and to treat the members of a class equally.³⁶⁰ For instance, a plan proponent may put substantially similar claims into different classes, provide complex payout schemes that are difficult to value and assert that the claims allocated to the different classes are different in kind but equal in value. However, one class may claim that the debtor has been gerrymandering the voting or that they have been treated less favorably than the other similar claims that are put in a different class. In this situation, the court, if after examining the nature of the claims, it considers that those claims being put into different classes are actually similar, may solve the problem of gerrymandering and discrimination by requiring that the plan proponent puts all these substantially similar claims into one class and provides all the different kinds of payment as equal alternatives for the holders of the similar claims to choose between.³⁶¹

4.1.1.4 The efficient and inefficient elements of the supermajority rule

Judged against the standard established by the creditors' bargain theory, the supermajority voting rule is efficient in that it fosters interested parties bargaining and helps the multiple parties to avoid the hold up by objecting minorities and to reach a consensual agreement on a plan that maximizes the debtor's value.³⁶² Under the assumption that a majority rule should

³⁵⁹ See e.g., *In re Lettick Typographic*, 103 B.R. 32, 38-9 (Bankr. D.Conn. 1989) (the court refused to confirm the plan based on three grounds, two of which were related to classification. One of the grounds was that the classifications in the plan attempt to improperly manipulate the unsecured creditor class and neutralize objections to the plan. Another ground was that the debtor artificially created an impaired class by amending the draft plan and deferring the payment to one secured class for fifteen days in the amended plan); *In re Sandy Ridge Development Corp.*, 881 F.2d 1346, 1353 (5th Cir. 1989) (based on the fact that the creditors overwhelmingly rejected the plan, the court suspected that the plan artificially created the slightly impaired classes which were willing to give acceptance to the plan and that the debtor lacked good faith and remanded the matter to the bankruptcy court for reconsideration); *In re Sun Country Development*, 764 F.2d 406 (5th Cir. 1985) (change a creditor's status from unimpaired to impaired for the sole purpose of effecting a "cram down,"). See also Peter E. Meltzer (1992), *Disenfranchising the Dissenting Creditor through Artificial Classification or Artificial Impairment*, 66 Am. Bankr. L. J. 281, pp.316-8.

³⁶⁰ Douglas G. Baird, *ELEMENTS OF BANKRUPTCY*, Foundation Press, 4th edition, 261-2 (2006).

³⁶¹ *Id.*

³⁶² Thompson, Robert B. and Edelman, Paul H. (2009), *Corporate Voting*. 62 *Vanderbilt Law Review* 129, p. 132 (talking about one of the merits of majority voting is to help the group to avoid hold-up by the minority and reach a decision since there is no perfect way to aggregate the preferences of individuals into the preference of a group).

be adopted to avoid the hold up problem in the collective decision-making within one class, which majority rule is suitable in the context of reorganization bargaining needs further exploration. Compared with the simple majority rule, i.e. a rule that requires the consent of more than half of the total amount, the supermajority rule, which requires the consent of more than two thirds of the total amount, increases the threshold of the votes for the class' acceptance of a plan. On the one hand a high majority requirement is efficient because it reduces the problem of minorities being expropriated by the majority. On the other hand, a high majority requirement is detrimental because it provides the minority with hold-up power in the sense that they can prevent the efficient decision from being made.³⁶³ The optimal majority requirement is the one with the best tradeoff between minority protection and hold-up minimization.

Skeel suspected that one of the reasons why legislators of Chapter 11 adopted the supermajority rule is that the supermajority rule provides stronger protection of the interests of the dissenting minorities of a class. As a reorganization plan often effectuates a material alteration of the pre-bankruptcy entitlements of a voting class, whether to accept the plan is closely related with the protection of the interests of the claimholders, the supermajority rule may provide better protection of the interests of claimholders since it requires the consent of more than two-thirds of the total amount.³⁶⁴ However, Skeel further pointed out that special protection of the minority is not quite necessary in the class voting of a bankruptcy reorganization procedure. The rest of this paragraph is a summary of Skeel's main line of reasoning. The supermajority rule is prevalent in the context of close corporations, where the majority shareholders may abuse their dominant power to pass some corporate decisions, which by nature have disproportionate impact over the majority and minority shareholders.³⁶⁵

³⁶³ Thompson, Robert B. and Edelman, Paul H. (2009), Corporate Voting. 62 Vanderbilt Law Review 129, p. 132-3.

³⁶⁴ David A. Skeel, Jr. (1992), The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases, 78 Virginia Law Review 461, p. 489 ("reorganization plans effect an alteration of the prebankruptcy contractual rights of dissenting voters against their wishesthe drafters may have concluded as a matter of policy that a supermajority vote was needed to effect such an effect"). Scott F. Norberg (1998), Debtor Incentives, Agency Costs, and Voting Theory in Chapter 11, 46 U. Kan. L. Rev. 507, p. 535.

³⁶⁵ For example, in a close corporation where the majority shareholders are top managers while minority shareholders are not managers and simply get benefits of their investment by receiving dividends, a decision that increases the salary of the corporations' top managers and stops paying dividends, may have a disproportionate impact on majority shareholder and minority shareholders. David A. Skeel, Jr. (1992),

In a close corporation, a minority shareholder's major fear is that the majority shareholders may vote for decisions that improve the welfare of majority shareholders without giving minority shareholders comparable benefits. For a minority shareholder holding 34% of the total share, the supermajority rule is more desirable than the simple majority rule, since the supermajority rule makes it difficult for the majority shareholders to pass decisions without the assent of the minority shareholder.³⁶⁶ However, in the context of a reorganization procedure, each member of a class is affected in the same way since the claims in one class must be substantially similar and the treatment of each class member must be the same. If the assenting members of a class receive a payment of 80% of their claims under a plan, so do the dissenting members of the same class. Because each member of the same class is affected in the same way by the outcome of the vote, the need to protect the interest of the dissenting minority and the need for the adoption of the supermajority rule is not as strong that in the context of a close corporation where the corporate decision may affect the majority shareholder and minority shareholder in a different way.³⁶⁷ Therefore, compared to the simple majority rule, the supermajority rule does not have an obvious merit in enhancing minority protection and increasing the probability of a correct decision is not obvious.

Norberg commented that the supermajority rule "decreases the instances in which the votes of insiders or others with additional stakes in the firm will be able to override the desires of disinterested claim holders."³⁶⁸ For example, claims held by insiders may dominate a class and the insiders may vote to protect their interests as shareholders and managers instead of their interests as creditors. Another example is that under-secured creditors who also hold unsecured claims (the deficiency amount of an under-secured claim) may vote for their interests as secured creditors instead of as unsecured creditors. However, the supermajority

The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases, 78 Virginia Law Review 461, pp. 448-90.

³⁶⁶ David A. Skeel, Jr. (1992), The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases, 78 Virginia Law Review 461, pp. 488-9.

Frank H. Easterbrook and Daniel R. Fischel (1986), Close Corporations and Agency Costs, 38 Stan. L. Rev. 271, pp. 296-7 (discussing that the minority shareholders' veto power is necessary for protecting their interests)

³⁶⁷ David A. Skeel, Jr. (1992), The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases, 78 Virginia Law Review 461, p. 489-90.

³⁶⁸ Scott F. Norberg (1998), Debtor Incentives, Agency Costs, and Voting Theory in Chapter 11, 46 U. Kan. L. Rev. 507, p. 535.

rule is not a proper and effective device for such a problem, because it is uncertain in a specific case how much percent of the total amount of the claims of one class will be held by members who vote with an incentive of promoting their other kinds of interests instead of their interest as the class members. If claims with right voting-incentives constitute more than one half but less than two thirds of the total amount of the class, the supermajority rule actually obstructs efficient decision-making and hinders the protection of the interests of the class. Therefore, this kind of problem should be solved by other devices, such as non-calculation of the votes of claimholders who hold other interests which materially conflict with their interests as class members, invalidating the votes of a claimholder who did not cast his vote with good faith.

Skeel suspected that another reason for the adoption of the supermajority rule is the problem of uninformed voting. Shareholders and unsecured creditors of a publicly held corporation “may be small and dispersed enough so that they have insufficient incentives to cast their vote in an informed fashion for or against a reorganization proposal”, since informed voting is accompanied by the costs incurred in securing and evaluating information, developing capacity etc.³⁶⁹ For example, many unsecured creditors may be willing to accept any payment—however small—rather than face further delay. Because this problem may give the plan proponent an upper hand, the supermajority requirement may be considered by the legislators as a response to this collective action problem.³⁷⁰ However, the supermajority rule is not a proper and effective device for such a problem. First, the problem of the dispersed members’ reluctance in bearing the cost for making an informed decision cannot be solved by lifting the standard of the requisite majority, but should be solved by devices that help the dispersed members to acquire the necessary information and to make an informed decision, such as the establishment of a committee for unsecured creditors and shareholders, the employment of professional agents by a committee etc. Since the uninformed decision may lead to incorrect rejection or acceptance, it is uncertain whether the supermajority rule may contribute to the quality of the decision. In order to improve informed decisions, legal

³⁶⁹ David A. Skeel, Jr. (1992), *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 *Virginia Law Review* 461, pp. 520-25.

³⁷⁰ David A. Skeel, Jr. (1992), *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 *Virginia Law Review* 461, p. 489.

devices, such as the committee device, information disclosure obligation of the debtor, are more suitable solutions.

To conclude, in the context of bankruptcy reorganization, compared with the simple majority rule, the merit of the supermajority rule with respect to the protection of the minority and the production of efficient decision is unclear or ambiguous.

4.1.2 The confirmation system under the US law

4.1.2.1 Overview of the confirmation system

Based on the result of class voting, there are two kinds of courts confirmation of the proposed plan: confirmation of a consensual plan and confirmation of a non-consensual plan (“cram down”).³⁷¹ A plan that has been accepted by all classes during class voting (“a consensual plan”) will finally become effective if it is confirmed by the court.³⁷² The court should examine the consensual plan judged against a series of requirements provided by Chapter 11. Since under Chapter 11, the requirements for the confirmation a consensual plan also apply in the confirmation of a non-consensual plan, these requirements are referred to as “general confirmation requirements”.³⁷³

Among the general confirmation requirements, the major ones are the best-interest-test³⁷⁴ and the feasibility test³⁷⁵. The best-interest-test requires that each dissenting member of an impaired class receives a distribution with a present value no less than what he would receive under a hypothetical liquidation on the effective date of the plan.³⁷⁶ This test is applied to each dissenting member of an impaired class rather than to his class as a whole.³⁷⁷ The

³⁷¹ “Confirmation” is a general term which means courts’ confirmation of both consensual plans and non-consensual plans. “Cram down” is a term that specially means confirmation of non-consensual plans. See e.g. Kenneth N. Klee (1979), *All You Ever Wanted to Know about Cram Down under the New Bankruptcy Code*, 53 Am. Bankr. L. J. 133.

³⁷² 11 U.S.C. §1129 (a).

³⁷³ The general confirmation requirements that apply to non-consensual plans refer to the provisions in 11 U.S.C. § 1129(a), except 11 U.S.C. § 1129(a)(8), which requires that the plan should be either accepted by all the impaired classes and is a provision that deals with the definition of a consensual plan.

³⁷⁴ 11 U.S.C. §1129(a)(7)(ii).

³⁷⁵ 11 U.S.C. §1129(a)(11).

³⁷⁶ Natalic Regoli (2005), *Confirmation of Chapter 11 Bankruptcy: A Practical Guide to the Best Interest of Creditors Test*, 41-SPG Tex. J. Bus. L. 7, p. 91.

³⁷⁷ Kenneth N. Klee (1979), *All You Ever Wanted to Know about Cram Down under the New Bankruptcy Code*, 53 Am. Bankr. L. J. 133, p. 137.

feasibility test requires that the plan is not likely to be followed by liquidation or the need of another reorganization of the debtor unless such liquidation or reorganization is proposed in the plan, or that the plan is likely to succeed in practice.³⁷⁸

Besides the best-interest-test and the feasibility test, Chapter 11 contains other general confirmation requirements. Firstly, Chapter 11 requires that a plan should disclose any payments for the services or for costs and expenses in connection with the plan and the case (“adequate disclosure of all the reorganization fees”).³⁷⁹ This is to ensure that all the expenses incurred in a reorganization case are under comprehensive supervision. Moreover, Chapter 11 requires that the plan and the plan proponent should comply with all the bankruptcy law and the plan has been proposed in good faith and not by any means forbidden by the law (“good faith and general validity test”).³⁸⁰ This may serve as a general restraint over the plan proponent to ensure that the plan is proposed for achieving the legitimate purpose and is in conformity with all the applicable laws. The term “good faith” is not defined in the US Code. Case law suggested that a plan generally is considered as proposed in good faith “if there is reasonable likelihood that the plan will achieve a result consistent with the objectives and purposes of the Code.”³⁸¹ Courts have further held that in evaluating whether a plan has been proposed in good faith the court must look to the “totality of the circumstances” surrounding the development and proposal of the plan.³⁸² In addition, 11 U.S.C. §1129(a)(5) provides that

³⁷⁸ The purpose of the feasibility requirement is to prevent confirmation of a visionary scheme that promises more than the debtor can possibly achieve. *In re Gulph Woods Corp.*, 84 B.R. 961, 973 (Bankr. E.D. Pa. 1988). The plan need only offer a reasonable assurance of success, not a guarantee. *Kane v. Johns-Manville Corp.* (In re Johns-Manville Corp.), 843 F.2d 636, 649-50 (2d Cir. 1988).

³⁷⁹ 11 U.S.C. §1129(a)(4).

³⁸⁰ 11 U.S.C. §1129(a)(1); (2); (3).

³⁸¹ *In re Gen. Teamsters, Warehousemen & Helpers Union*, 265 F.3d 869 (9th Cir. 2001) (a good faith plan is one which satisfies the purposes of the Code, which include facilitating the successful rehabilitation of the debtor and maximizing the value of the estate). See also, *In re PWS Holding Corp.*, 228 F.3d 224, 232 (3d Cir. 2000); *In re Madison Hotel Assocs.*, 749 F.2d 410, 424-25 (7th Cir. 1984).

³⁸² *In re Machne Menachem, Inc.*, 48 Bankr. Ct. Dec. 23 (3d Cir. 2007) (The court affirmed the reversal of a confirmation order where an insider “gerrymandered” the voting process by purchasing unsecured claims during the case to ensure that an impaired class of claims would vote in favor of the plan. The insiders’ purchase of claims to ensure acceptance of the plan by an impaired class was deemed bad faith.) *Financial Sec. Assurance v. T-H New Orleans Ltd. P’ship* (In re T-H New Orleans Ltd. P’ship), 116 F.3d 790, 802 (5th Cir. 1997) (“The requirement of good faith must be viewed in light of the totality of circumstances surrounding establishment of a Chapter 11 plan, keeping in mind the purpose of the Bankruptcy Code to give debtors a reasonable opportunity to make a fresh start. Where the plan is proposed with the legitimate and honest purpose to reorganize and has a reasonable hope of success, the good faith requirement of § 1129(a)(3) is satisfied. A debtor’s plan may satisfy the good faith requirement even though the plan may not be one which the creditors would themselves design and indeed may not be confirmable.”) (citations omitted).

the plan must disclose the identity and affiliations of the top managers of the reorganized debtor, any of the debtor's affiliations that participate in a joint plan or the successor of the debtor participating in the plan, the identity of the insiders that will be employed in the reorganized debtor and the compensation to be paid to such insiders ("adequate disclosure of information concerning the new and old management").³⁸³ This provision forces the plan-drafter to disclose the necessary information to the interested parties which is essential for the judge and the interested parties to judge whether the reorganized debtor will be put in capable hands and whether the compensation to the debtor's insiders is reasonable.³⁸⁴

If a plan is not accepted by all voting classes, the plan proponent may apply for confirmation of the plan under the condition that at least one impaired class, excluding the votes of insiders,³⁸⁵ has accepted the plan.³⁸⁶ Because insiders may vote to promote their interests as shareholders or managers instead of their interests as creditors, this requirement helps to ensure that the vote is not tainted by these claimants' conflicting equity or employment interests. It should be noted that the consent of a class that is deemed to have accepted the plan because it is unimpaired does not satisfy the one class' consent requirement provided in §1129(a)(10).³⁸⁷ By excluding the ballots from insiders and the presumed consent of unimpaired classes, §1129(a)(10) aims to ensure that one "real" class of creditors accepts the plan.³⁸⁸ Besides the general confirmation requirements provided in §1129(a) and the one impaired class' consent, a crammed-down plan must satisfy the cram-down requirements provided in §1129(b). The central content of the cram-down requirements is that the plan does not discriminate unfairly ("non-discrimination-test") and that the plan is fair and equitable ("fair-and-equitable-test").³⁸⁹ The cram-down requirements only apply to the dissenting classes rather than to all classes or the plan as a whole.

³⁸³ 11 U.S.C. §1129(a)(5).

³⁸⁴ See e.g., *In re SM 104 Ltd.*, 160 B.R. 202 (S.D. Fla. 1993) (ruling that "[w]here the proposed officer or director has previously engaged in serious misconduct in managing the debtor . . ., employment is improper under § 1129(a)(5)").

³⁸⁵ The term "insider" is defined in 11 U.S.C. § 101 (31) in a broad sense. If the debtor is a corporation, insiders include officers, directors, and any other person in control of the debtor.

³⁸⁶ 11 U.S.C. §1129(a)(10).

³⁸⁷ 11 U.S.C. §1129(a)(10).

³⁸⁸ Scott F. Norberg (1998), *Debtor Incentives, Agency Costs, and Voting Theory* in Chapter 11, 46 U. Kan. L. Rev. 507, pp. 537-8. Linda J. Rusch (1992), *Gerrymandering the Classification Issue in Chapter Eleven Reorganization*, 63 U. Colo. L. Rev. 163, pp. 1187-9.

³⁸⁹ 11 U.S.C. §1129(b)(1).

Among the two requirements, the non-discrimination-test plays a fundamental role. The non-discrimination-test is intended to “be complementary to a fair and equitable test and to permit the court to evaluate the complex relationship inherent in the relative priority of classes caused by partial subordination.”³⁹⁰ In determining whether a plan discriminates unfairly, focus is upon the classification and treatment of the different claims. “If the plan protects the legal rights of a dissenting class in a manner consistent with the treatment of other classes whose legal rights are intertwined with those of the dissenting class, then the plan does not discriminate unfairly with respect to the dissenting class.”³⁹¹ For example, a plan that segregates similar claims into separate classes and provides disparate treatment for those classes may be found by the court to contain unfair discrimination.³⁹² The notion of a fair-and-equitable-test is to ensure fair and equitable distribution of the debtor’s value to the dissenting classes. In order to determine whether a plan is fair and equitable, a concrete test—the absolute priority rule must be applied to check the distribution of the debtor’s value in the plan.

The absolute priority rule originated from the equity receivership cases for dealing with the problem of shareholders’ continued participation in the reorganized debtor while unsecured creditors did not receive full payment.³⁹³ It requires that a dissenting senior class must be paid in full before any junior class receives any payment and that no classes senior to a dissenting class may receive more than full payment. In other words, a dissenting senior class must receive full payment if classes junior to it receive anything and may receive less than full payment if classes junior to it receive nothing. A corollary of the absolute priority rule, not expressly stated in the US Code, is that classes senior to the dissenting classes should not receive more than full payment.³⁹⁴ Thus, the absolute priority rule allows the

³⁹⁰ Kenneth N. Klee (1979), All You Ever Wanted to Know about Cram Down under the New Bankruptcy Code, 53 Am. Bankr. L. J. 133, p. 141.

³⁹¹ Kenneth N. Klee (1979), All You Ever Wanted to Know about Cram Down under the New Bankruptcy Code, 53 Am. Bankr. L. J. 133, pp. 142-3.

³⁹² Gerald F. Munitz (2006), The Chapter 11 Plan: Proposal, Confirmation, and Effect of Confirmation, Practising Law Institute, Commercial Law and Practice Course Handbook Series, PLI Oder No. 9087, pp. 1032-4.

³⁹³ See the milestone cases: Northern Pacific Ry. Co. v. Boyd, 228 U. S. 482 (1913) and Case v. Los Angeles Lumber Products Co., Ltd., 308 U. S. 106 (1939). For the development history of the absolute priority rule, see , Bruce A. Markell (1991), Owners, Auctions, and Absolute Priority in Bankruptcy Reorganization, 44 Stan. L. Rev. 69, pp. 78-103.

³⁹⁴ See Kenneth N. Klee (1990), Cram Down II, 64 Am. Bankr. L. J. 229, pp. 231-2. Kenneth N. Klee

shareholders to receive the remaining value of the debtor after all the dissenting senior classes receive full satisfaction of their claims and prohibits the shareholders from receiving any payment before all the dissenting senior classes receive full satisfaction of their claims. Compared with the absolute priority rule under the 1938 Act, Chapter 11 adopts a relaxed version of the absolute priority rule in permitting senior assenting classes to give up value to a junior class as long as all dissenting classes with a priority level higher than that junior class receive full payment.³⁹⁵ The absolute priority rule is the substantial and concrete content of the fair-and-equitable test.³⁹⁶ Theoretically, it is not clear whether the treatment of secured creditors is within the regulation scope of the absolute priority rule. For instance, Baird thinks that the absolute priority rule is a general principle that is “to ensure that creditors in bankruptcy are paid according to their nonbankruptcy priorities.”³⁹⁷ By contrast, Klee thinks that the absolute priority rule is to regulate the distribution among unsecured creditors and shareholders and that 1129(b)(2)(A) is a specific provision which ensures that a dissenting class of secured creditors should be not only receive full payment in value and but this should also be one of the three specific kinds of payments.³⁹⁸ Nevertheless, the spirit reflected in protecting secured creditors in their receipt of full payment is the same as that of the absolute priority rule.³⁹⁹

(1979), *All You Ever Wanted to Know about Cram Down under the New Bankruptcy Code*, 53 *Am. Bankr. L. J.* 133, pp. 142-6. Lynn M. LoPucki and William C. Whitford (1993), *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 *U. Pa. L. Rev.* 669, p. 682.

³⁹⁵ Kenneth N. Klee (1979), *All You Ever Wanted to Know about Cram Down under the New Bankruptcy Code*, 53 *Am. Bankr. L. J.* 133, pp. 143-5.

³⁹⁶ Kenneth N. Klee (1979), *All You Ever Wanted to Know about Cram Down under the New Bankruptcy Code*, 53 *Am. Bankr. L. J.* 133, pp. 142; Bruce A. Markell (1991), *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganization*, 44 *Stan. L. Rev.* 69, pp. 71-2.

³⁹⁷ Douglas G. Baird, *ELEMENTS OF BANKRUPTCY*, Foundation Press, 4th edition, 24 (2006).

³⁹⁸ “The Code adopts three different tests to determine whether a plan is fair and equitable, depending on whether the dissenting class is comprised of secured claims, unsecured claims, or ownership interests. The tests regarding unsecured claims and ownership interests essentially apply a relaxed version of the traditional absolute priority rule....However, the test for secured claims is completely novel....” Kenneth N. Klee (1979), *All You Ever Wanted to Know about Cram Down under the New Bankruptcy Code*, 53 *Am. Bankr. L. J.* 133, pp. 142-3.

³⁹⁹ The House Report on the 1978 Bankruptcy Code states that “The general principle of the subsection [§1129 (b)] permits confirmation notwithstanding nonacceptance by an impaired class if that class and all below it in priority are treated according to the absolute priority rule. The dissenting class must be paid in full before any junior class may share under the plan. If it is paid in full, then junior classes may share. Treatment of classes of secured creditors is slightly different because they do not fall in the priority ladder, but the principle is the same.” House Report, p. 6369.

4.1.2.2 The efficient and inefficient elements of the confirmation system

The confirmation system is a type of judicial supervision that serves as the final-step in the screening of the content of the reorganization plan. Judged against the standard established by the creditors' bargain theory, the efficient elements of the confirmation system mainly lie in that it helps to ensure that only the efficient plan, i.e. the plan that maximizes the debtor's value, will take effect at the end of the reorganization procedure. The main substance of the general confirmation requirements, i.e. the best-interest-test and feasibility test, is analyzed below.

(1) The efficient and inefficient elements of the best-interest-test

According to the creditors' bargain theory, the goal of the bankruptcy proceeding is the maximization of the debtor's overall value and reorganization and liquidation are equal alternatives between which the interested parties may freely choose to achieve that goal.⁴⁰⁰ If the reorganization plan is efficient, the debtor's overall value is maximized under the plan, the total recovery of the creditors as a whole is maximized. The best-interest-test is efficient in that it checks whether the plan is efficient by requiring that every objecting claimholder receives no less than what he would receive under liquidation. Generally one may assume that a reasonable claimholder will object to a plan if the value of the distribution he receives under the plan is less than what he would receive under a hypothetical liquidation. Thus, if a claimholder objects to a plan, even if the class, to which he belongs, has accepted the plan, there is a need for the court to step in and check whether reorganization is more efficient than liquidation and whether the dissenting claimholder receives no less than what he would receive under liquidation. Therefore, the best-interest-test is a device employed by the law to check the efficiency of reorganization where the plan meets with some objection and to provide an important baseline protection of the interests of the dissenting claimholders.⁴⁰¹

The best-interest-test is inefficient in that it incurs cost since it requires a series of complicated valuations. The best-interest-test requires the calculation of the debtor's liquidation value and reorganization value, the present value of the distributions to the

⁴⁰⁰ See Section 2.1.1.1.

⁴⁰¹ Natalic Regoli (2005), Confirmation of Chapter 11 Bankruptcy: A Practical Guide to the Best Interest of Creditors Test, 41-SPG Tex. J. Bus. L. 7, p. 9.

objecting claimholders under the reorganization plan and the value of the distribution to objecting claimholder under a hypothetical liquidation. For instance, there are problems in making a liquidation analysis, such as whether the court should adopt a going-concern liquidation or piecemeal liquidation, an orderly sale or a quick sale,⁴⁰² as the method for getting the hypothetical liquidation value, how to calculate the liquidation value since the hypothetical administrative expenses of liquidation may not be easily quantified.⁴⁰³ While it is difficult to make the liquidation analysis, it may be even more difficult to make the reorganization analysis, which involves the calculation of the debtor's reorganization value and the value of the distribution to the dissenting claimholders under the plan.⁴⁰⁴

(2) The efficient and inefficient elements of the feasibility test

According to the creditors' bargain theory, an efficient bankruptcy rule should help the reorganization procedure to produce an efficient reorganization plan that maximizes the debtor's overall value. An efficient plan should be feasible. The feasibility test is efficient in that it prevents "visionary schemes" from being confirmed and ensures that the confirmed plan contains an efficient scheme. An efficient plan should not only promise a reorganization value, which is higher than the liquidation value, but also contain a feasible operation scheme that provides reasonable assurance of the realization of that higher value.⁴⁰⁵

The feasibility test is inefficient in that it is costly for the court to judge whether a plan is

⁴⁰² "Under an orderly liquidation approach, the debtor values its assets based on the pricing it may obtain if it sells its assets to the market over time. In contrast, under a fire sale liquidation approach, the debtor bases its pricing on flooding the market with its assets over a short period of time. In certain circumstances, an orderly valuation may be the most appropriate methodology for preparing a liquidation analysis, while in others, a fire sale approach may be preferred. The court determines whether an orderly or fire sale valuation methodology is more appropriate depending on which approach maximizes returns to creditors, and depending on the facts of each case." Natalic Regoli (2005), Confirmation of Chapter 11 Bankruptcy: A Practical Guide to the Best Interest of Creditors Test, 41-SPG Tex. J. Bus. L. 7, pp. 26-7.

⁴⁰³ Natalic Regoli (2005), Confirmation of Chapter 11 Bankruptcy: A Practical Guide to the Best Interest of Creditors Test, 41-SPG Tex. J. Bus. L. 7, p. 26-8.

⁴⁰⁴ See e.g., Natalic Regoli (2005), Confirmation of Chapter 11 Bankruptcy: A Practical Guide to the Best Interest of Creditors Test, 41-SPG Tex. J. Bus. L. 7, p. 29-30; Kerry O'Rourke (2005), Valuation Uncertainty in Chapter 11 Reorganizations, 2005 Colum. Bus. L. Rev. 403, pp. 427-9; T. Roe (1983), Bankruptcy and Debt: A New Model for Corporate Reorganization, 83 Colum. L. Rev. 527, p. 548; Raymond T. Nimmer (1987), Negotiated Bankruptcy Reorganization Plans: Absolute Priority and New Value Contributions, 36 Emory. L. J. 1009, pp. 1046-7; Chaim J. Fortgang and Thomas Moers Mayer (1985), Valuation in Bankruptcy, 32 UCLA L. Rev. 1061, pp. 1123-30.

⁴⁰⁵ See e.g., *In re Bowman*, 253 B.R. 233, 238-39 (8th Cir. BAP 2000); *In re Sea Garden Motel & Apts.*, 195 B.R. 294, 304 (D.N.J. 1996); *Miller v. Nauman* (*In re Nauman*), 213 B.R. 355, 358 (9th Cir. BAP 1997); *Kane v. Johns-Manville Corp.* (*In re Johns-Manville Corp.*), 843 F.2d 636, 649 (2nd Cir. 1988).

feasible or not. Case law has developed detailed standards for applying the feasibility test. “Sincerity, honesty and willingness are not sufficient to make the plan feasible, and neither are any visionary promises.”⁴⁰⁶ The court may not rely on highly speculative and unduly optimistic assumptions and must base its findings of feasibility on the evidence presented.⁴⁰⁷ Feasibility does not require absolute assurance of success but only reasonable assurance of success.⁴⁰⁸ Case law has suggested that bankruptcy courts frequently consider the following factors in determining the feasibility of a plan: (i) the debtor's prior performance, (ii) the adequacy of the debtor's capital structure, (iii) the earning power of the business, (iv) economic conditions, (v) the ability of management and the probability of the continuance of the same management, and (vi) any other matter that may affect the debtor's ability to perform the plan.⁴⁰⁹

4.1.2.3 The efficient elements of cram down

Compared with confirmation of a consensual plan, confirmation of a non-consensual plan, i.e. the justification of cram down deserves special attention, since it imposes a plan on the dissenting classes. Moreover, if cram down is proved to be necessary, the cram down rules need to be examined in order to see whether they ensure that crammed-down plans maximize the debtor's value, distribute debtor's value in a fair and equitable way and protect the interest of the dissenting classes. In addition, since the parties bargain in the shadow of cram down, the cram-down rules have great impact over the parties' decision on whether to

⁴⁰⁶ See e.g., *Clarkson v. Cooke Sales & Serv. Co. (In re Clarkson)*, 767 F.2d 417, 420 (8th Cir. 1985); *In re Investors Fla. Aggressive Growth Fund, Ltd.*, 168 B.R. 760, 765 (Bankr. N.D. Fla. 1994).

⁴⁰⁷ See e.g., *Pan Am Corp. v. Delta Air Lines, Inc.*, 175 B.R. 438, 508 (S.D.N.Y. 1994); *In re Snider Farms, Inc.*, 83 B.R. 1003, 1014 (Bankr. N.D. Ind. 1988). In effect, a court is required to predict, based on the historical data provided by the parties, whether the debtor will be able to make all payments under the plan and to otherwise comply with the plan. *In re Snider Farms, Inc.*, 83 B.R. 1003, 1006 (Bankr. N.D. Ind. 1988) (“A plan will not be confirmed where, for example, there is no realistic possibility of an effective reorganization and the debtor is merely seeking to delay the efforts of creditors to enforce their rights.”)

⁴⁰⁸ See *Kane v. Johns-Manville Corp. (In re Johns-Manville Corp.)*, 843 F.2d 636, 649 (2nd Cir. 1988) (“Success need not be guaranteed.”); *Miller v. Nauman (In re Nauman)*, 213 B.R. 355, 358 (9th Cir. BAP 1997).

⁴⁰⁹ Barbara J. Houser, Douglas Wade Carvell, and Holly D. F. Meister (2010), *Disclosure Statements: Confirmation and Cramdown of Chapter 11 Plans*, SR047 ALI-ABA 449, part IV. See *In re Canal Place Ltd. P'ship*, 921 F.2d at 579 (5th Cir. 1991); *In re U.S. Truck*, 800 F.2d 587, 589 (N.D. Ill. 1992); *Pfeifer*, 189 B.R. 173 (Bankr. N.D. Ind. 1995), 186; *In re Immenhausen Corp.*, 172 B.R. 343, 348 (Bankr. M.D. Fla. 1994); *In re Landing Assoc., Ltd.*, 157 B.R. 791, 819 (Bankr. W.D. Tex. 1993).

accept a plan.⁴¹⁰ Therefore, the efficient and inefficient elements of the cram-down system and the substantial cram-down requirement—the absolute priority rule is explored in detail below.

Judged against the standard established by the creditors' bargain theory, the efficient elements of cram down mainly lie in the fact that cram down makes it possible for an efficient plan to go ahead and become effective at the end of the reorganization procedure without being held up by a voting class that has a distorted decision-making incentive.

If all the participating parties in the reorganization procedure are equally positioned as residual owners of the reorganization decision and thus have the right decision-making incentives, the reorganization law may simply rely on the voting based on a majority rule to reach the final decision. However, in the reorganization context, the claimholders are differently positioned and their decision-making incentives maybe skewed. This leads to the necessity of cram down, which serves as an important device to help an efficient plan obtain legal effect even if it fails to get consensual acceptance in the voting procedure.

At bottom, the skewed incentives are caused by the valuation problem and the separation of cost-bearing from benefits-sharing in the reorganization procedure. In the reorganization decision making process, the participating parties faced with the liquidation vs. reorganization problem, will compare what they receive under liquidation with that under reorganization. To the extent they would receive different payment under liquidation, they bear different cost for reorganization.⁴¹¹ However, the costs borne by a class of claimholders for the reorganization when the decision between liquidation and reorganization is made is not the only factor determining how much reorganization value the claimholders will receive. The reorganization value is distributed according to special reorganization rules, such as the absolute priority rule.⁴¹² Jackson commented that, in bankruptcy reorganization, senior classes, who bear the cost for the reorganization, do not reap all the benefits of reorganization; junior classes, who

⁴¹⁰ Kenneth N. Klee (1979), All You Ever Wanted to Know about Cram Down under the New Bankruptcy Code, 53 Am. Bankr. L. J. 133, p. 134.

⁴¹¹ "So long as the company remains in reorganization, the risk of investment loss is borne largely by senior classes while the possibility of investment gain accrues largely to junior classes." Lynn M. LoPucki and William C. Whitford (1993), Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies, 141 U. Pa. L. Rev. 669, p. 753.

⁴¹² Thomas H. Jackson (2001), The Logic and Limits of Bankruptcy Law, Bear Books, pp.212-3 (commenting the relationship between distribution of the reorganization value and the absolute priority rule).

bear no cost for the reorganization, may enjoy part of the benefits of reorganization.⁴¹³ This leads to the separation of cost-bearing from benefits-sharing, which may cause skewed decision-making incentives in different classes of claimholders. Where a debtor corporation is insolvent, junior classes, typically shareholders, who would receive nothing under liquidation, have a strong incentive to delay the shut down of the debtor's business and pursue a risky reorganization, even if liquidation is efficient, since they will lose nothing if the reorganization fails and might gain something if it succeeds. Senior classes, typically being secured creditors, who may receive full payment, often have a strong incentive to push for immediate liquidation, since they bear the cost for the reorganization, but they often share the benefits with those who do not bear cost for the reorganization and may not get adequate compensation for the cost they bear because of the valuation problem in calculating the compensation, such as the difficulty in finding the proper post-petition interest rate and the post-confirmation interest rate for the delay in receiving payment caused by reorganization.⁴¹⁴ Because the voting parties' decision-making incentives may be skewed, a reorganization law without cram down would allow a voting class with skewed incentives to turn down an efficient plan and destroy all the valuable rescue efforts. Cram down is efficient in that it may conquer the hold out by voting classes with distorted incentives. This results in a reliable reorganization procedure likely to lead to an efficient reorganization plan. Moreover, cram down is efficient in that it puts pressure on the interested parties to strike a deal of their own.⁴¹⁵ All the interested parties bargain in the shadow of cram down,⁴¹⁶ if they expect to go through a costly cram-down procedure that results in confirmation of the same

⁴¹³ , Thomas H. Jackson (2001), *The Logic and Limits of Bankruptcy Law*, Bear Books, pp.216-7.

⁴¹⁴ , Lynn M. LoPucki and William C. Whitford (1993), *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. Pa. L. Rev. 669, pp.683-6. Lynn M. LoPucki (1993), *The Trouble with Chapter 11*, 1993 Wis. L. Rev. 729, pp. 732-4. Philippe Aghion, Oliver Hart, and John Moore (1994), *Improving Bankruptcy Procedure*, 72 Wash. U. L. Q. 849, pp. 858-60. Thomas H. Jackson (2001), *The Logic and Limits of Bankruptcy Law*, Bear Books, pp. 216-7. , Chaim J. Fortgang and Thomas Moers Mayer (1985), *Valuation in Bankruptcy*, 32 UCLA L. Rev. 1061, pp. 1067-86; 1113-21.

⁴¹⁵ "[T]he risks of failure to reach a settlement are so great, and the possible negative impact of the imposition of the cramdown powers so significant, that the cramdown power is used more as a threat than as a club actually employed in confirming a plan of reorganization. Further, in an arena where timing is often more important than the ideal result, the delay caused by invocation of the cramdown power is likely to result in harm to all." (footnote omitted) Richard F. Broude (1984), *Cram Down and Chapter 11 of the Bankruptcy Code: The Settlement Imperative*, 39 Bus. Law. 441, p. 441.

⁴¹⁶ Kenneth N. Klee (1979), *All You Ever Wanted to Know about Cram Down under the New Bankruptcy Code*, 53 Am. Bankr. L. J. 133, p. 134.

plan they will be forced to vote in favor of such a plan that maximizes the debtor's overall value.

4.1.2.4 The inefficient elements of cram down

Cram down has inefficient elements because the valuations involved in cram down are quite costly. First, cram down needs a valuation of the debtor's reorganization value. The cram down procedure involves determination and comparison of the debtor's value under the proposed plan and other alternatives, such as liquidation. To ensure that only efficient plans are confirmed, the court needs to make the right judgment of whether the debtor's value under a proposed plan is higher than its value under other alternative deployment solutions, such as liquidation.⁴¹⁷ However, it is not easy to make a correct valuation. If the valuation of the debtor is wrong, an inefficient plan may be crammed down.⁴¹⁸ Second, cram down requires valuation of the different kinds of distribution to the different classes in order to ensure a fair and equitable distribution of the debtor's value in cram down.⁴¹⁹ In order to check whether the plan being crammed down meets with the fair-and-equitable test, which revolves around the absolute priority rule, the cram down procedure requires a valuation of the distributions to different classes.⁴²⁰ To get a good understanding of the inefficient elements of cram down, the problems in the valuation of the debtor and the distribution to the different classes of claimholders are discussed below.

(1) Problems with the judicial valuation of the debtor

In the cram down procedure, an important issue is the court's valuation of the debtor based on the deployment project proposed by the plan. Chapter 11 does not provide clear rules for judicial valuation in cram down; the legislators intended the court to determine the value on a

⁴¹⁷ The best-interest-test provided in 11 U.S.C. 1129(a)(7)(ii) requires a valuation of the debtor in order to determine whether each dissenting member of an impaired class will receive under the plan no less than what it would receive under liquidation. In order to prove to the court that the proposed plan passes the best-interest-test, the plan proponent must prepare a liquidation analysis, which produces sufficient current financial information about the debtor, the debtor's assets and liabilities. Moreover, it also requires the valuation of the present value of the distribution to the individual dissenting claimholders. Natalic Regoli (2005), Confirmation of Chapter 11 Bankruptcy: A Practical Guide to the Best Interest of Creditors Test, 41-SPG Tex. J. Bus. L. 7, pp. 23-6.

⁴¹⁸ Omer Tene (2003), Revisiting the Creditors' Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy Reorganizations, 19 Bankr. Dev. J. 287, pp. 360-2.

⁴¹⁹ 1129(b)(1); (2).

⁴²⁰ Chaim J. Fortgang and Thomas Moers Mayer (1985), Valuation in Bankruptcy, 32 UCLA L. Rev. 1061, pp. 1105-31.

case-by-case basis.⁴²¹ Judicial valuation in cram down is problematic. First, judges, who are generally not valuation professionals, may not apply the valuation methodologies correctly. Second, a judge often has his personal bankruptcy policy opinions and may thus be influenced by the policy and equitable factors in addition to economics. In choosing a higher or lower value, a judge tends to emphasize proper allocation of risk according to bankruptcy policy and equity, instead of making an independent economic calculation.⁴²²

(2) Problems in calculating the present value of the distribution to secured creditors

With respect to the distribution to a dissenting class of secured creditors, Chapter 11 provides that the payment provided by the plan should conform to the specific kinds of treatment provided in §1129(b)(2)(A). In order to ensure that a dissenting class of secured creditors receives payment of which the current value is equal to the value of the secured claim and to ensure that their security right is not damaged, §1129(b)(2)(A) provides that a crammed down plan may contain three provisions in respect of secured creditors. First, the plan may provide deferred cash payment with the creditor retaining a lien on the same collateral regardless of who owns the collateral and the present value of the cash payment should be equal to the amount of the secured claim.⁴²³ Second, the plan may provide for selling the collateral free and clear of the lien under the condition that the creditor has the chance to bid and the lien attaches to the proceeds. In this situation, the plan may provide repayment to the class by using one of the two methods that are prescribed in the first and third provision.⁴²⁴ For the sake of clarity, this involves the conversion of collateral from a specific type of non-cash property into cash, using the cash as the lien for the creditors and adopting the payment method described in the first or third provision.⁴²⁵ Third, the plan may propose that the

⁴²¹ “A statutory valuation formula would have been helpful. The committee has considered a number of suggested formulas but has been unable to come up with a satisfactory one. The valuation problem is, therefore, left to the referees and judges.” House Report, p. 6176. “Courts will have to determine value on a case-by-case basis, taking into account the facts of each case and the competing interests in the case.” Id, p. 6312.

⁴²² Raymond T. Nimmer (1987), *Negotiated Bankruptcy Reorganization Plans: Absolute Priority and New Value Contributions*, 36 Emory. L. J. 1009, pp.1046-7.

⁴²³ 11 U.S.C. §1129(b)(2)(A)(i)(2007). Kenneth N. Klee (1979), *All You Ever Wanted to Know about Cram Down under the New Bankruptcy Code*, 53 Am. Bankr. L. J. 133, p. 155.

⁴²⁴ 11 U.S.C. §1129(b)(2)(A)(ii).

⁴²⁵ Kenneth N. Klee (1979), *All You Ever Wanted to Know about Cram Down under the New Bankruptcy Code*, 53 Am. Bankr. L. J. 133, p. 155.

creditor realizes the “indubitable equivalent” of his allowed secured claim.⁴²⁶ The term “indubitable equivalent” is vague and makes this provision the most unclear of the three. It is uncertain whether unsecured notes or equity securities of the reorganized debtor constitutes “indubitable equivalent”.⁴²⁷ In practice, the application of the third provision generally turns out to involve collateral substitution combined with deferred cash payment (deferred cash payment with the creditors holding a lien on the cash proceeds from the sale of the collateral or a lien on a substitute collateral), or paying the creditors by abandoning the collateral to the creditor.⁴²⁸

Since deferred cash payment is an important kind of distribution to secured creditors and future cash payment offered under the plan should be discounted at a proper rate to calculate the present value, the choice of a proper discount rate becomes very important. A discount rate proposed in the plan and confirmed by the court, may be considered by a dissenting creditor as lower than the appropriate rate and thus the “full payment” confirmed by the court is considered by the dissenting creditor as less than full payment.

Generally courts agree that the market rate of similar commercial loans (the “similar market rate”) should be the standard for determining the discount rate under cram down.⁴²⁹ How can the similar market rate be calculated? Some courts adopt the market rate of similar loans in the area including the general institutional lending rate or the lender’s own lending rate. Some courts select a formula rate, which is a riskless prime rate, such as the rate of U.S. Treasury securities of the same duration, plus a risk factor, such as 2%. Some courts adopt the pre-bankruptcy contract rate if they conclude that it reflects the market rate or if they lack other evidence of the market rate.⁴³⁰ The significant problem in determining the discount rate

⁴²⁶ 11 U.S.C. §1129(b)(2)(A)(iii).

⁴²⁷ Jack Fridman (1993), What Courts Do to Secured Creditors in Chapter 11 Cram Down, 14 *Cardozo L. Rev.* 1495, pp.1539-42(discussing the controversy and ambiguity concerning whether the debtor’s unsecured debt and equity could be crammed down on a dissenting secured creditor). Kenneth N. Klee (1979), All You Ever Wanted to Know about Cram Down under the New Bankruptcy Code, 53 *Am. Bankr. L. J.* 133, p. 156 (commenting that unsecured notes or equity securities of the reorganized debtor would not constitute the indubitable equivalent of secured claims).

⁴²⁸ Jack Fridman (1993), What Courts Do to Secured Creditors in Chapter 11 Cram Down, 14 *Cardozo L. Rev.* 1495, pp. 1508-1541.

⁴²⁹ Jack Fridman (1993), What Courts Do to Secured Creditors in Chapter 11 Cram Down, 14 *Cardozo L. Rev.* 1495, pp. 1514-5. Waltraud S. Scott (1988), Deferred Cash Payments to Secured Creditors in Cram Down of Chapter 11 Plans: A Matter of Interest, 63 *Wash. L. Rev.* 1041, p. 1045.

⁴³⁰ Jack Fridman (1993), What Courts Do to Secured Creditors in Chapter 11 Cram Down, 14 *Cardozo L.*

is that the discount rate determined by the court generally diverges from the reality of the loan contained in the crammed-down plan. In selecting the market rate, the court gives little weight to the actual characteristics of the debtor and the creditor, rarely analyzes the proper components of the market rate or the objective basis for quantifying the risk factor and decides the rate according to transactions of generalized debtors and creditors.

The fundamental reason for the divergence from reality is that there is no real loan market that is exactly similar to the loan transaction within the Chapter 11 procedure. In reality there is a limited loan market for debtors that have recently emerged from Chapter 11. Moreover, a forced loan in Chapter 11 also has special characteristics. In a Chapter 11 case where the creditor is under-secured, the secured portion is just equal to the value of the collateral. But in actual commercial markets, loans equal to the value of the collateral are not common, since any diminution in the value of the collateral would leave the secured creditor unsecured.⁴³¹

Another problem in selecting a proper rate is that courts often reduce the market rate by a 'profit' element. Usually, their decisions do not clearly explain what is meant by "profit". The ground for denying the inclusion of the profit factor was that the underlying policy of the bankruptcy reorganization law is to make the creditors whole, but without "profit" because calculating the discount rate solely from the perspective of a hypothetical similar loan in the market requires that the profit component be included and this hypothetical market rate might be so high that it may defeat the rehabilitative ideal of the bankruptcy reorganization law.⁴³²

Rev. 1495, pp. 1516-7.

⁴³¹ Jack Fridman (1993), What Courts Do to Secured Creditors in Chapter 11 Cram Down, 14 *Cardozo L. Rev.* 1495, p. 1519. See e.g. *In re Computer Optics, Inc.*, 126 B.R. 664, 672 (Bankr. D.N.H. 1991) ("[T]here is no 'market' in the real world for 'similar loans' when dealing with a reorganized entity coming out of a chapter 11 proceeding . . ."); *In re Aztec*, 107 B.R. 585, 588 (Bankr. M.D. Tenn. 1989) ("Chapter 11 does not implode merely because there is no 'market' for loans of the sort that can be forced upon a secured claimholder under § 1129 (b).").

⁴³² Jack Fridman (1993), What Courts Do to Secured Creditors in Chapter 11 Cram Down, 14 *Cardozo L. Rev.* 1495, p. 1519. Waltraud S. Scott (1988), *Deferred Cash Payments to Secured Creditors in Cram Down of Chapter 11 Plans: A Matter of Interest*, 63 *Wash. L. Rev.* 1041, pp. 1046-51. See, e.g., *In re E.I. Parks No. 1 Ltd. Partnership*, 122 B.R. 549, 554 (Bankr. W.D. Ark. 1990), the court noted: "Utilizing a hypothetical coerced loan as a governing analogy overlooks some important dissimilarities to the chapter 11 cramdown process. For example, the hypothetical coerced loan necessarily includes a factor for profit, a factor most courts have rejected for purposes of calculating the market rate of interest to be applied in a bankruptcy case. In addition, many lenders would decline to make any loan secured by collateral equal to 100% of the amount of the loan, especially to a debtor in chapter 11. When asked what rate they would charge for a hypothetical coerced loan, lenders invariably state that the rate charged would be the maximum allowed by law. Calculating the market rate of interest solely from the viewpoint of a coerced loan tends to jeopardize the success of a chapter 11 plan and defeat the rehabilitative purposes of bankruptcy reorganization." (citations omitted); In *Barrington Oaks* the court stated: "The

Scott commented that “[a] nominal interest rate has three components: Inflationary expectations, a ‘real’ rate of interest, and certain risk premiums”, and that by denying the ‘profit’ element, courts refused to include a proper risk premium in the interest rate.⁴³³ Or in other words, the exclusion of the ‘profit’ element implies that “courts indirectly deny the creditors’ compensation for the coerced taking of the creditor’s current use of funds.”⁴³⁴

(3) Problems in valuing the collateral for the purpose of determining the amount of the secured claim

For the purpose of making distribution to a secured claim, the amount of a secured claim must be determined first. In order to determine the exact amount of a secured claim, one needs to value the collateral. Valuation of the collateral presents complex problems, such as the valuation standard, the relationship of valuation for the purpose of adequate protection and plan confirmation. §506(a), which governs the determination of the value of the secured claim, simply provides that the value shall be “determined in light of the purpose of the valuation and of the proposed disposition or use of such property”.⁴³⁵ Obviously, the language of

market may also overlook the purpose of Section 1129(b)(2)(A)(i)(II) to protect creditors from loss rather than to augment their opportunity for profitmaking under a plan. Moreover, it may give insufficient weight to the continuing jurisdiction of the court and other protective features of the Code, as well as the rehabilitative ideal.” Barrington Oaks, 15 B.R. 952, 964 (footnote omitted). In contrast, one court has specifically stated that the proposition that “profit” for a lender is not appropriate in the bankruptcy context has no authority in the 1978 Code. *In re Arnold*, 80 B.R. 806, 809-10 (Bankr. M.D. La. 1987).

⁴³³ Waltraud S. Scott (1988), *Deferred Cash Payments to Secured Creditors in Cram Down of Chapter 11 Plans: A Matter of Interest*, 63 Wash. L. Rev. 1041, p. 1046. “If inflation occurs while a loan is outstanding, the amount of money lent will have a lower purchasing power when it is repaid. Lenders want to be protected against loss of purchasing power caused by inflation. Interest rates reflect the market’s expectations about future inflation rates.” “The ‘real’ interest rate is the price required to induce a lender to effect an exchange between current and future consumption. Preferences and endowment tend to be stable, though recessions and booms, reflecting expected changes in productivity, may temporarily influence the real interest rate. [The real interest rate component is estimated to fluctuate between 2% and 4%.” “Inflationary expectations and the real rate of interest are the same for all borrowers. The risk premium accounts for differences in interest rates obtained by individual borrowers in the market. Interest rates on loans considered low-risk are lower than interest rates on high-risk loans.” *Id.*, at 1046-50. In order to provide the creditors with proper compensation for the risk in a coerced Chapter 11 loan, risk premium should be calculated based on the specific risk in the Chapter 11 loan. Thus, courts denied to include the risk-premium if they support the debtor’s argument that a high interest rate will “give the creditor more than the value of its claim, to the detriment of other creditors and equity holders, and that it will threaten a successful reorganization”. *Id.*, at 1055-7.

⁴³⁴ *Id.*, at 1050.

⁴³⁵ “An allowed claim of a creditor secured by a lien on property is a secured claim to the extent of the value of such creditor’s interest in the estate’s interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor’s interest or the amount so subject to setoff is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor’s interest.” 11 U.S.C. 506(a)(1).

§506(a) provides no clear guidance concerning the details of valuation.⁴³⁶

First, courts have used different standards for valuing the collateral. Some courts adopted the going-concern value method. They conducted a valuation from the perspective of the debtor and considered that the value should be the amount the debtor would have paid to purchase similar property elsewhere, i.e. replacement price or retail price or the value of the collateral as part of the operating business, i.e. the collateral's going-concern value.⁴³⁷ Some courts considered that the valuation should be conducted from the perspective of creditors and adopted the liquidation-valuation method, i.e. wholesale price (the price for which an item is sold at wholesale), foreclosure price (the price that the creditor might receive in a foreclosure sale).⁴³⁸ Some courts adopted an intermediate position by choosing the midpoint between the two values. The underlying reasoning was that the debtor and the secured creditors would agree a deal splitting the difference between the two values between them if they were to bargain outside of bankruptcy or if that midpoint valuation is the most equitable solution to the disputes.⁴³⁹ Moreover, the collateral may be valued in differing circumstances. For

⁴³⁶ The U.S. Supreme Court commented that the words “the creditor's interest in the estate's interest in such property” does not impart any valuation standard. *Associates Commercial Corporation v. Rash*, 520 U.S. 953, 117 S.Ct. 1879, at 960-1.

⁴³⁷ See, e.g. *In re Winthrop Old Farm Nurseries*, 50 F.3d 72, 73-75 (1st Cir. 1995) (noting that some courts reason that “because the reorganizing debtor proposes to retain and use the collateral, it should not be valued as if it were being liquidated; rather, courts should value the collateral “in light of” the debtor's proposal to retain it and ascribe to it its going-concern or fair market value with no deduction for hypothetical costs of sale”, and that the court agrees with this reasoning); *Taffi v. United States* (*In re Taffi*), 96 F.3d 1190, 1192-93 (9th Cir. 1996) (“By agreeing to the Plan and allowing the [debtors] to retain their [collateral], the [[creditor] runs a risk. It is appropriate that it also benefits from the higher valuation.”); *In re Trimble*, 50 F.3d 530, 532 (8th Cir. 1995). Omer Tene (2003), *Revisiting the Creditors' Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy Reorganizations*, 19 *Bankr. Dev. J.* 287, pp. 311-2; Chris Lenhart (1998), *Toward A Midpoint Valuation Standard in Cram Down: Oitment for the Rash Decision*, 83 *Cornell L. Rev.* 1821, pp.1839-45.

⁴³⁸ See e.g., *In re Ledgemere Land Corp.*, 125 B.R. 58, 61 (Bankr.D.Mass.1991) (bank's mortgage on Chapter 11 debtor's real property that debtor intended to retain and eventually develop “is worth only what [property] will bring at foreclosure”); *In re Robbins*, 119 B.R. 1, 5 (Bankr.D.Mass.1990) (valuing Chapter 11 debtor's investment property at foreclosure value); *In re T.H.B. Corp.*, 85 B.R. 192, 196 (Bankr.D.Mass.1988) (“The fact that the Debtor is a going concern is no reason to value the collateral under the going concern standard unless it appears likely that the secured party will actually receive that value from its collateral through a pending sale.”). Chaim J. Fortgang and Thomas Moers Mayer (1985), *Valuation in Bankruptcy*, 32 *UCLA L. Rev.* 1061, pp. 1073-4. Omer Tene (2003), *Revisiting the Creditors' Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy Reorganizations*, 19 *Bankr. Dev. J.* 287, pp. 312-3; Chris Lenhart (1998), *Toward A Midpoint Valuation Standard in Cram Down: Oitment for the Rash Decision*, 83 *Cornell L. Rev.* 1821, pp.1831-8.

⁴³⁹ Judge Posner opined that the midpoint serves as “a natural point to which bargaining parties will gravitate if they don't want to waste a lot of time in bluffing and haggling”. *In re Hoskins*, 102 F.3d 311, 316 (7th Cir. 1996). *In re Myers*, 178 B.R. 518, 524 (Bankr. W.D. Okla, 1995) (holding that the midpoint valuation “represents a compromise” that will provide an equitable result). Omer Tene (2003), *Revisiting the Creditors' Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy*

instance, a valuation for the purpose of adequate protection and a valuation for the purpose of plan confirmation. Generally it is considered that a court's valuation calculated in an earlier stage is not binding on that which occurs in a later stage. Thus, the valuation made for the purpose of adequate protection during the automatic stay is not binding at plan confirmation stage.⁴⁴⁰

(4) Problems in valuing the distribution to unsecured creditors and shareholders

In the cram down context, there are not only problems in valuing the distribution to secured creditors, but also problems in valuing the distribution to unsecured creditors and shareholders. In the reorganization of a big corporation, there may be claimholders of different priority, such as general unsecured claimholders, subordinated unsecured claimholders, preferred shareholders, and common shareholders. The distribution of the value to the claimholders of different priority must satisfy the fair-and-equitable test. The fair-and-equitable test revolves around the absolute priority rule that requires that a dissenting senior class must receive full payment before any junior class receives any payment.⁴⁴¹ Where a class of unsecured creditors or shareholders objects to the plan, complicated valuations will be needed in order to calculate the present value of the payment to the objecting class and the other relative classes.

Where the distribution to a class of dissenting unsecured creditors is deferred cash payment, like the deferred cash payments to secured creditors, the deferred cash payment to unsecured creditors involves the determination of the proper discount rate for calculating the present value. "To the extent that no underlying collateral secures the payout, risk increases and so should the discount rate. Otherwise, the determination of the proper discount rate for cram down of unsecured creditors should parallel the determination of rates for cram down of

Reorganizations, 19 Bankr. Dev. J. 287, p. 313; Chris Lenhart (1998), Toward A Midpoint Valuation Standard in Cram Down: Oitment for the Rash Decision, 83 Cornell L. Rev. 1821, pp. 1845-51.

⁴⁴⁰ Chris Lenhart (1998), Toward A Midpoint Valuation Standard in Cram Down: Oitment for the Rash Decision, 83 Cornell L. Rev. 1821, p. 1825. See Fairchild v. Lebanon Prod. Credit Ass'n (In re Fairchild), 31 B.R. 789, 795 (Bankr. S.D. Ohio 1983) ("A determination of the amount of a secured claim in one aspect of a bankruptcy proceeding is not necessarily resjudicata in other aspects of that proceeding."); Provident Bank v. BBT (In re BBT), 11 B.R. 224, 229 n.10 (Bankr. D. Nev. 1981) ("Of course, the value determined in the light of the purpose of vacating the automatic stay may not be the same as the value for another purpose such as confirmation of a plan."); see also S. REP. No. 95-989, at 68 (1978) ("[A] valuation early in the case in a proceeding under sections 361-363 would not be binding upon the debtor or creditor at the time of confirmation of the plan.")

⁴⁴¹ See Section 4.1.2.1 for the implication of the fair-and-equitable test and the absolute priority rule.

secured creditors.”⁴⁴² Recall that there are problems in determining the discount rate for secured creditors,⁴⁴³ similar problems may lie in determining the discount rate for unsecured creditors.

Shareholders generally are paid by stock under a reorganization plan.⁴⁴⁴

Where the payment to a dissenting class of unsecured creditors or shareholders is made by shares, the valuation of the debtor’s stock is problematic. A senior class may claim that the present value of its distribution is less than full payment while a junior class may claim that a senior class has received more than full payment. The valuation of the debtor’s stock is based on the valuation of the debtor’s overall value. However, as discussed in part (1) of this Section, the judicial valuation of the debtor is problematic. The problems inherent in judicial valuation in calculating the present value of the stocks of the reorganized debtor affect the distribution to both unsecured creditors and shareholders. While the over-valuation of the stocks benefits the junior class, i.e. common shareholders, under-valuation of the stocks benefits the senior class, i.e. unsecured creditors.

4.1.2.5 The efficient elements of the absolute priority rule

The efficient elements of the absolute priority rule may be discussed with reference to three aspects.

First, according to the creditors’ bargain theory, the absolute priority rule is efficient in that by respecting the interested parties’ non-bankruptcy entitlements, it avoids wealth redistribution which may cause distorted incentives in the interested parties when they decide whether to adopt the reorganization procedure. Before entering into bankruptcy, the interested parties, based on their contract and non-bankruptcy law, have set up or bargained for a priority order for receiving payment in the situation where the debtor does not have enough assets to pay all the debts. For instance, subordinated unsecured creditors have bargained for a priority which

⁴⁴² Chaim J. Fortgang and Thomas Moers Mayer (1985), *Valuation in Bankruptcy*, 32 *UCLA L. Rev.* 1061, p. 1123.

⁴⁴³ See part (2) of this Section for the discussion of the problems in selecting the proper discount rate for the payment to secured creditors.

⁴⁴⁴ If shareholders are not paid by shares under a plan, it implies that their priority level is lifted under the plan, which will cause many problems, such as whether a senior dissenting class may be forced to take inferior securities while a junior class receives superior securities, to which the answer is unclear. Kenneth N. Klee (1990), *Cram Down II*, 64 *Am. Bankr. L. J.* 229, p. 237.

is below that of other general unsecured creditors,⁴⁴⁵ creditors have bargained to be paid before shareholders; preferred shareholders have bargained to be paid before the common shareholders. Some non-bankruptcy law, such as corporate law, may provide the priority order in paying all the claims and interest in cases where a debtor company has insufficient assets to pay its debts.⁴⁴⁶

According to the creditors' bargain theory, bankruptcy law should preserve the non-bankruptcy priority order established by the interested parties' contract and non-bankruptcy law and the bankruptcy priority order is simply a summarization and expression of the non-bankruptcy priority order. Jackson commented that the absolute priority rule, "as announced by Justice Douglas in *Case v. Los Angeles Lumber Products Co.*,⁴⁴⁷ seems designed to mimic relative nonbankruptcy entitlements. Under the absolute priority rule as articulated in *Case*, claimants were entitled to have their relative values respected in full, according exactly to their nonbankruptcy entitlements."⁴⁴⁸ Outside of bankruptcy, based on their contract and non-bankruptcy law, unsecured creditors generally have bargained for the right to withdraw their investment or to receive payment from the debtor before the shareholders in the event of business failure. The absolute priority rule is intended to guarantee that their pre-bankruptcy rights are respected inside bankruptcy.⁴⁴⁹ A bankruptcy procedure, be it a reorganization procedure or a liquidation procedure, is simply a procedure for maximizing the debtor's overall value. Although the debtor's overall value is enhanced in a bankruptcy procedure, the value should be distributed according to the order of priority

⁴⁴⁵ For instance, courts in a bankruptcy procedure rely on the clear content of the subordinated contract to establish the priority order between the senior and junior unsecured creditors. see e.g., *In re Southeast Banking Corp.*, 212 B.R. 682, 686, (S.D.Fla. 1997).

⁴⁴⁶ For example, Article 187 of the Company Law of the People's Republic of China ("Chinese company law") provides that where the debtor dissolves, the debtor's assets should be liquidated and the proceeds should first be used to pay all the unpaid claims. After paying all the claims, the remaining property shall be distributed to its shareholders. Article 188 further provides that where the debtor's assets are not enough to pay all the creditors, the company shall apply to the court for bankruptcy. Article 188 of Chinese company law reflects that although the bankruptcy priority order originally is a summarization and expression of the non-bankruptcy priority order, since bankruptcy law has come into existence and provided the priority order for all the claims and interests in a unified and clear way, the pre-bankruptcy contracts or non-bankruptcy law has become reliant on the bankruptcy law and may refer to the bankruptcy law for the priority order instead of directly providing the priority order.

⁴⁴⁷ *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939).

⁴⁴⁸ Thomas H. Jackson, *The Logic and Limits of Bankruptcy Law* (Bear Books, Washington, 2001), p. 213.

⁴⁴⁹ *Id.*

established under non-bankruptcy law.⁴⁵⁰ The absolute priority rule is efficient in that it respects the pre-bankruptcy entitlements bargained for by the interested parties and distributes the debtor's value among the unsecured creditors and shareholders in a reorganization procedure in accordance with the same order of priority as that under non-bankruptcy law and in a liquidation procedure. By respecting the non-bankruptcy order of priority, the absolute priority rule helps to avoid wealth redistribution in reorganization procedures, which may cause skewed incentives in the interested parties when they decide whether to adopt a reorganization procedure, liquidation procedure or out of court restructuring.

Second, the absolute priority rule helps to align risk-bearing with benefits-sharing and sets the right decision-making incentive for the interested parties. In reorganization, creditors generally bear more cost than shareholders. When the interested parties make the liquidation vs. reorganization decision, they compare what they receive under liquidation with that under reorganization. Insofar as under liquidation shareholders of an insolvent debtor would receive nothing, they bear no cost for the reorganization. By contrast, senior classes, who would receive full or partial payment under liquidation, bear a substantial part of the cost of reorganization.⁴⁵¹ Therefore, it is efficient to distribute the debtor's reorganization value according to the absolute priority rule, since this distributional model aligns cost-bearing with benefits-sharing and helps to ensure that interested parties an efficient decision about whether or not to reorganize .

Thirdly, the absolute priority rule fosters the reorganization bargaining and improves decision-making efficiency in bankruptcy reorganization. The interested parties bargain in the shadow of cram down.⁴⁵² By setting up a clear distributional standard for a crammed-down plan, the absolute priority rule reduces the complexity in the bargaining over the distribution of the debtor's value. The absolute priority rule structures the reorganization bargaining and shifts the reorganization bargaining effort away from the distribution of the debtor's value to the maximization of the debtor's overall value, i.e. including among other factors, the

⁴⁵⁰ Id, pp. 209-13.

⁴⁵¹ Thomas H. Jackson, *The Logic and Limits of Bankruptcy Law* (Bear Books, Washington, 2001), pp. 216-7. , Lynn M. LoPucki and William C. Whitford, 'Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies' (1993) 141 U. Pa. L. Rev. 669, pp. 683-6.

⁴⁵² Kenneth N. Klee (1979), All You Ever Wanted to Know about Cram Down under the New Bankruptcy Code, 53 Am. Bankr. L. J. 133, p. 134.

feasibility of the plan.

4.1.2.6 The inefficient elements of the absolute priority rule

The absolute priority rule is inefficient because its application is costly since it requires the valuation of the present value of the distribution to different classes. Although the absolute priority rule seems to be a good solution to the tension between the fair and equitable distribution of the debtor's value and the pursuit of the most efficient deployment of the debtor's assets, its application is problematic because of the difficulty in valuing the assets.⁴⁵³

The absolute priority rule requires that a senior dissenting class must be paid in full before any junior class receives anything and that classes senior to a dissenting class should not receive more than full payment. While a dissenting senior class may claim that its payment is less than full payment, a junior class may insist that that senior class have received more than full payment. The application of the absolute priority rule is costly because of the difficult valuations.⁴⁵⁴

4.2 The plan-passing system under Chinese law

4.2.1 The Classified voting system under Chinese law

4.2.1.1 Overview of the classified voting system

Under the EBL, a draft plan should be voted upon by creditors. For the purpose of voting on the draft reorganization plan, creditors' claims should be divided into four classes, which are the class of secured claims, employment claims, tax claims, and general unsecured claims. Moreover, the court may order the establishment of a class of small-amount unsecured claims, if the court considers such to be necessary.⁴⁵⁵ The court should convene a creditors'

⁴⁵³ Thomas H. Jackson, *The Logic and Limits of Bankruptcy Law* (Bear Books, Washington, 2001), p. 213 ("Because the rigors of the absolute priority rule in practice turn on the accuracy with which valuations are made, the absolute priority rule was frequently circumvented in practice.").

⁴⁵⁴ See Section 4.1.2.4 for the detailed discussion of the valuation problems in a cram down context.

⁴⁵⁵ Article 82 of the EBL provides: Creditors holding the following claims participate in the creditors meeting for the discussion of the reorganization plan. Creditors' claims should be divided into the following classes for the purpose of voting on the plan:

- (1) claims being secured by the debtor's specific assets;
- (2) claims arising out of employment relationships, which include unpaid wages, medical expense, wound and disability pension, pension for bereaved families, basic pension and medical care

meeting within 30 days from the date that the draft plan is received by the court. A class is deemed to have approved the plan if more than one-half of the creditors present at the meeting (“the simple majority rule”) vote to accept the plan and the assenting creditors hold at least two-thirds of the total claim of the class (“the supermajority rule”).⁴⁵⁶ A minor difference between the voting rule of the EBL and Chapter 11 is that the EBL requires the consent of more than one-half of the members that are present at the meeting in which votes are cast while the Chapter 11 requires the consent of more than one-half of the total members of one class. This difference makes the voting rule under the EBL less strict than that under Chapter 11.

Under the EBL, shareholders do not always have the right to vote on the draft plan. In order to ensure that the opinion of shareholders is heard and considered by the creditors, the EBL provides that the representatives of shareholders may be present at the creditors’ meeting in which the draft plan is discussed.⁴⁵⁷ The EBL provides that in cases where the draft plan involves an adjustment of the interests of the shareholders of the debtor, the draft plan should be voted for by the class of shareholders.⁴⁵⁸ In total, under the EBL, all the claims may be divided into five classes: classes of secured claims, employment claims, tax claims, general unsecured claims and shareholders’ claims.

4.2.1.2 The efficient elements of the classified voting system

Similar to Chapter 11, the EBL adopts a classified voting system to foster decision-making efficiency. Judged against the standard established by the creditors’ bargaining theory—the maximization of the debtor’s value, the classified voting under the EBL, just like its counterpart under Chapter 11, is efficient in that it fosters bargaining efficiency and reduces bargaining cost since it changes the bargaining among many individuals into a bargaining among several structured classes, encourages the claimholders within one class to conduct

insurance, and other compensations for the employees provided by the law and regulations;

(3) tax claims owned by the debtor;

(4) general unsecured claims.

The court, if it deems, may decide to establish a class of small-amount unsecured claim for the purpose of voting on the plan.

⁴⁵⁶ The EBL, Art. 84.

⁴⁵⁷ The EBL, Art. 85, paragraph one.

⁴⁵⁸ The EBL, Art. 85, paragraph two.

collective bargaining and allows the consent of the majority to bind the objecting minority of one class. Moreover, the EBL is different from Chapter 11 in that the EBL provides clearly that all the creditors and shareholders should be divided into five classes while Chapter 11 empowers the plan proponent to design the proper classification based on the specific circumstances of the case. By adopting a fixed approach in classification, the EBL provides no room for the plan proponent to manipulate the voting result by strategic classification.

4.2.1.3 The inefficient elements of the classified voting system

The EBL's classified voting system has inefficient elements because its provisions with respect to classification and shareholders' voting rights are problematic, which may hinder the bargaining parties from making an efficient final decision. A detailed analysis is below.

(1) Problems in the classification system

The EBL's classification system, which rigidly classifies all the creditors and shareholders into five classes, is problematic, since the claims or interests within one class may not be substantially similar.

First, the secured claims of the debtor are often quite different from each other. The nature of a secured claim is mainly affected by two elements, i.e. the stability of the value of the collateral and the ratio of the nominal amount of the claim to the value of the collateral. Where the nature of the debtor's secured claims is different, even if a plan provides the same payment scheme to these secured claims, whether or not a specific secured claim is treated fairly and equitably should be judged with reference to the specific nature of that secured claim. In this situation, it is unreasonable to put all the secured claims into one class and use the consent of some secured creditors to bind the objecting secured creditors. Suppose the debtor company X has three secured claims and the plan provides deferred cash payment in two years for all the secured claims. One secured claim is \$2,000 secured by a new building valued at \$4,000 and the value of the building is expected to increase in the next two years. Another secured claim is \$1,800 secured by another old but solid building valued at \$1,900 and the value of the building is expected to be stable in the next two years. The third secured claim is \$1,600 secured by a car valued at \$1,600 and the value of the car is expected to decline in the next two years. In order to provide compensation to the secured creditors for the

delay, the plan should choose a proper interest rate for different secured creditors based on the risk they bear. Obviously, the \$1600 claim should be provided with a much higher interest rate for the deferred payment since the holder bears much higher risk than the other two secured creditors. However, even if the plan provides the same interest rate for the three secured claims and the holder of the \$1600 claim objects to the plan, based on the classification and the majority voting rule of the EBL, the consent of the holders of the \$2,000 and the \$1,800 claim effectively results in the plan being accepted by the class of the secured claims. Obviously, the consent of some secured creditors can not be taken as evidence of fair and equitable treatment of the dissenting secured creditor since their claims are substantially different and thus should be treated differently.

Second, a similar problem exists in putting general unsecured claims or shareholders' interests into one class. Within unsecured creditors, there may be groups with different priority levels. For instance, some unsecured creditors may have agreed to be paid after the other unsecured claims and thus there may be general unsecured creditors and subordinated unsecured creditors. Thus, the unsecured claims of the debtor may differ substantially and should not be put into one class. Among the shareholders, there may be preferred shareholders and common shareholders, whose interests are quite different and should be treated differently.

Based on the preceding analysis we may infer that the rigid classification system under the EBL can result in claims or interests being put into one class that may not be substantially similar. However, it is the fact that the claims within one class are substantially similar that provides the foundation for the equal treatment of claims within one class and the application of the majority voting rule (using the majority opinions of one class to bind the whole class) efficient bargaining through class representatives. The development history of US reorganization law and the provision of the current US bankruptcy code reveals that it is the character of being substantially similar that justifies the pro rata distribution or the same treatment of class members, the class members' bargaining through representation, and the majority voting rule for the decision-making within one class.⁴⁵⁹

Generally, the character of the security that guarantees the payment of a secured claim is

⁴⁵⁹ The House Report states that § 1122 "requires classification based on the nature of the claims or interests classified, and permits inclusion or interests in a particular class only if the claim or interest being included is substantially similar to other claims or interests of the class." House Report, p.6326.

recognized as the major factor that decides whether secured claims are substantially similar. In contrast, the priority level of unsecured claims and shareholders' claims is considered as the major factor that decides whether secured claims, unsecured claims, and shareholders' claims are substantially similar to each other.⁴⁶⁰ The EBL's broad classification method, which puts all the secured claims into one class without examining the character of each secured interest, and puts unsecured claims or shareholders' claims into one class without examining their priority level, fails to ensure a proper classification of the claims and interests, undermines the operation of classification and the majority voting system and damages the efficiency of the decision produced by the voting mechanism.

(2) Problems in the voting right of shareholders

With respect to the voting right of shareholders, the EBL's provision is problematic. The EBL provides that in cases where the draft plan involves an adjustment of the interests of the shareholders, it should be voted on by the class of shareholders.⁴⁶¹ What does the term "adjustment of the interests of the shareholders" mean? A study of the cases may provide an explanation. The disclosed information concerning the voting on the draft plan in the 18 reorganization cases revealed that if a plan contains a distribution of shares of the reorganized debtor to the old creditors or new financiers, the plan was considered as involving "adjustment of the interests of the shareholders of the debtor" and was voted on by the shareholders.⁴⁶²

However, even if a plan does not use the debtor's shares to pay the old creditors or the new investors, the plan still affects the interest of the shareholders. First, deciding the debtor's overall value and the present value of the distribution to the different classes needs shareholders' participation. The voting system reveals that the EBL, just as Chapter 11, first permits the interested parties to bargain for the purpose of reaching an agreement concerning the debtor's value and the distribution of the debtor's value. Therefore, under Chapter 11, all

⁴⁶⁰ "Creditors who have liens or security interests in property of the debtor are entitled to preferential treatment by virtue of their security interests. Others ranked in order of priority in accordance with the rules of bankruptcy law and their rights under prevailing nonbankruptcy law." Brian A. Blum (2006), *Bankruptcy and Debtor/Creditor: Examples and Explanations*, Aspen Publishers, 4th Ed., p. 99. The House Report states that secured creditors, by nature, are most often in single-member class. House Report, p.6195.

⁴⁶¹ The EBL, Art. 85, paragraph two.

⁴⁶² In 5 of the 18 cases, i.e. the case of Hualong, Beiya, Haina, Cixian, and Chaohua, the old shareholders continue to keep all the shares of the reorganized debtor and the plan was voted only by creditors. In the other 13 cases, the plan was voted by the class of shareholders because a certain portion of the shares of the reorganized debtor was distributed to the old creditors or new financiers. See Appendix B.

the interested parties, including shareholders, should participate in the collective bargaining and have a say about the debtor's reorganization value and how much they are entitled to receive.⁴⁶³ The holders of common stock are entitled to the debtor's residual value.⁴⁶⁴ In a case where a plan does not provide the debtor's shares as a form of payment to creditors or new financiers, if the debtor's overall value or the distribution to creditors is under-valued, the plan damages the interest of shareholders. For example, the interest rate contained in the deferred payment scheme for the secured creditors or general unsecured creditors may be so high that the plan unfairly reduces the value remaining to the shareholders.⁴⁶⁵ Therefore, since the EBL adopts structured bargaining among interested parties to reach agreement, i.e. a reorganization plan, on how to deploy the debtor's assets, the value of the debtor and how to distribute that value, shareholders should always be allowed to participate in the voting, since a reorganization plan always influences the shareholders' interests. Without a voting right, shareholders cannot bargain to protect their interest.

4.2.2 The confirmation system under Chinese law

4.2.2.1 Overview of the confirmation system

Under the EBL, if a plan is accepted by all the voting classes, within 10 days of the date on which the consensual acceptance was gained, the plan proponent should apply to the court for confirmation of the plan. The court should examine the plan and decide whether to confirm it within 30 days. If the court, after examination, considers that the plan is in conformity with the provisions of the EBL, it should rule to confirm the plan, terminate the reorganization procedure and issue public notice.⁴⁶⁶ If a draft plan is accepted by some but not all of the

⁴⁶³ The parties, whose rights are to be affected, "should be able to make informed judgment of their own, rather than having the court or the securities and exchange commission inform them in advance of whether the proposed plan is a good plan." House Report, p. 6185. Brian A. Blum (2006), *Bankruptcy and Debtor/Creditor: Examples and Explanations*, Aspen Publishers, 4th Ed. , pp. 492-3.

⁴⁶⁴ Chaim J. Fortgang and Thomas Moers Mayer (1985), *Valuation in Bankruptcy*, 32 *UCLA L. Rev.* 1061, p. 1126.

⁴⁶⁵ Since all the claimholders have the incentive of trying to get a higher distribution, there are conflicts between the senior classes and junior classes concerning valuation of the debtor and the valuation of the different kind of distributions to the different classes designed in the reorganization. See Chaim J. Fortgang and Thomas Moers Mayer (1985), *Valuation in Bankruptcy*, 32 *UCLA L. Rev.* 1061, pp. 1105-31; Lucian Arye Bebchuk (1988), *A New Approach to Corporate Reorganization*, 101 *Harv. L. Rev.* 775, pp. 778-9.

⁴⁶⁶ The EBL, Art. 86.

voting classes, the plan proponent may negotiate with the dissenting classes. The negotiation result should not damage the interests of the other classes. The dissenting classes may vote on the plan again after the negotiation.⁴⁶⁷ If the dissenting classes refuse to vote on the plan or vote against the plan in the second round of voting, the plan proponent may apply to the court for cramming down the draft plan. Under the EBL, a plan may be crammed down if it meets with the following requirements (“cram-down requirements”):⁴⁶⁸

- (1) the class of secured claims will receive full payment and fair compensation for the delay in receiving the payment and their security right is not materially damaged; or such class has accepted the draft plan;
- (2) the class of employment claim and tax claim will receive full payment; or such classes have accepted the draft plan;
- (3) the repayment ratio of the class of unsecured claim is not lower than that under a hypothetical liquidation procedure; or such class has accepted the draft plan;
- (4) the adjustment of the interest of shareholders is fair and equitable; or the class of shareholders has accepted the draft plan;
- (5) the draft plan treats the members of one class fairly and the payment order does not violate Article 113 of the EBL;⁴⁶⁹
- (6) the debtor’s operation scheme is feasible.

If the court, after examining the draft plan, considers that the draft plan satisfies the cram-down requirements, the court should rule to confirm (“cram down”) the plan within 30 days from the date of receiving the application, terminate the reorganization procedure and

⁴⁶⁷ The EBL, Art. 87, paragraph one.

⁴⁶⁸ The EBL, Art. 87, paragraph two.

⁴⁶⁹ Article 113 of the EBL defines the priority order among unsecured claims in the liquidation procedure. It provides that bankruptcy assets, after being used to pay the bankruptcy fee and the fees incurred for common benefits, should be paid according to the following priority order: (1) salary claims, medical fee claims, wound and disability compensation claims, social insurance claims that should be paid to the employees’ bank account, other compensations that should be paid to the employees according to the applicable laws and regulations; (2) social insurance claims that are not included in the claims listed in item (1) and tax claims; (3) general unsecured claims. In item (2), the term “social insurance claims that are not included in the claims listed in item (1)” actually means the social insurance fee that should be paid to parties other than the employees, i.e. the social insurance fees that should be paid to the relevant insurance organizations. To summarize, the priority order among the unsecured claims is such: employment claims; second, social insurance claim held by non-employee parties and tax claims; third, general unsecured claims. By referring to Article 113, Article 87 provides that among unsecured claims, insurance fee claims held by insurance organizations should be paid first before other general unsecured claims.

issue public notice.⁴⁷⁰

4.2.2.2 The efficient elements of the confirmation system

Just as Chapter 11, the EBL adopts the court's confirmation as the final step of the decision-making process of the reorganization plan. Judged against the standard proposed by the creditor's bargain theory, the judicial confirmation of consensual plans is efficient in that it adds a necessary screening of the consensual plans, the court will screen the content and make sure that only an efficient plan is confirmed by the court and becomes effective. The court's cram down of non-consensual plans is efficient because it causes the bargaining parties to accept a plan that meets with the cram-down requirements and helps an efficient plan to become effective and to avoid being held up by a class with distorted decision-making incentives.

4.2.2.3 The inefficient elements of the confirmation system

Just as its US counterpart the EBL's confirmation system is inefficient in that it requires a costly valuation of the debtor and the distribution to the dissenting classes. In addition, compared with its US counterpart, the EBL's confirmation system is inefficient in that the EBL's provisions concerning the general confirmation requirements and cram-down requirements have some problems which may hinder the interested parties and the court from devising an efficient plan. A detailed analysis is below.

(1) Lack of detailed provisions on the general confirmation requirements

With respect to the general confirmation requirement, i.e. the confirmation requirement for the consensual and non-consensual plans, the EBL does not provide any detailed requirement. It simply provides that the court should confirm a consensual plan if the plan is in conformity with the provision of the EBL. The court is left with no detailed guidance in examining a consensual plan. By contrast, Chapter 11 provides a series of detailed general confirmation requirements, such as the best-interest-test, the feasibility test, adequate disclosure of all the reorganization fees, good faith and general validity test, adequate disclosure of information concerning the new and old management.⁴⁷¹

⁴⁷⁰ The EBL, Art. 87.

⁴⁷¹ See Section 4.1.2.1.

Although efficient plans cannot be completely identical to each other, they contain certain common elements and meet certain standards. If bankruptcy law does not codify such contents and standards as requirements for plan confirmation, bargaining parties need to conquer great difficulties in each case in order to reach a consensual agreement that contains such elements and meets such standards. However, sometimes efficient plans might fail to be produced due to factors such as bounded rationality, conflicts of interests, lack of information, inactive participation in the bargaining etc. Chapter 11 is more efficient than the EBL since it codifies these elements and standards in bankruptcy law as mandatory requirements so the bargaining parties are guided to reach an efficient plan and in the process avoid substantial bargaining cost. According to the creditors' bargain theory, efficient bankruptcy law should mimic the hypothetical bargaining result and help the interested parties to avoid the problems in their real bargaining and to reach an efficient plan at minimal cost. The EBL is inefficient because its legislative vacancy in detailed provisions on the general confirmation requirement may lead to bargaining cost and even a failure to produce an efficient plan.

(2) Lack of the best-interest-test and feasibility test as a general confirmation requirement

The best-interest-test, which is a general confirmation requirement for protecting every dissenting member of an assenting class under Chapter 11, is adopted by the EBL only as a cram-down test for the distribution to a dissenting class of general unsecured claims. Similarly, the feasibility test, a general confirmation requirement under Chapter 11, is only a cram-down test under the EBL. Recall that the best-interest test and the feasibility test are very essential confirmation requirements for ensuring that the confirmed reorganization plan is efficient.⁴⁷² By seriously limiting the application scope of these two tests, the EBL lowers its protection of the dissenting claimholders' interests and its screening of the efficiency of both consensual and non-consensual plans.

In order to study the feasibility of the confirmed plans in China, the author put the main content of the description of rehabilitation in the plans of the 18 cases together and made Appendix C. Among the plans of the 18 cases, 8 plans⁴⁷³ stated that the debtor would try to find the new financier but did not make it clear who would be the new financier. In the 10

⁴⁷² See Section 4.1.2.2 for the detailed analysis.

⁴⁷³ The plan of the following 8 cases: Baoshuo, Jiufa, Hualong, Huayuan, Beisheng, Guangming, Danhua, Dixian.

plans that stated the identity of the new financier, only 5 plans⁴⁷⁴ stated how much new finance would be needed and only one plan⁴⁷⁵ stated the consideration for the new finance. Moreover, in the 18 plans, only 5 plans⁴⁷⁶ talked about the business that the debtor would do in order to improve its profitability.⁴⁷⁷ Finally, none of the 18 plans stated the adequacy of the debtor's capital and the expected earning capacity.⁴⁷⁸

According to detailed standards of the feasibility test developed by US case law, a feasible plan should show a feasible operation scheme; visionary promises, sincerity, honesty or willingness does not fulfill the feasibility test; to meet with the feasibility test, the plan should show the adequacy of the debtor's capital structure, the earning power of the business, and the ability of the management etc. Judged against the standards under US case law, none of the 18 plans stated a feasible business operation scheme.⁴⁷⁹ Although the feasibility test is provided as a cram-down requirement in the EBL, none of the four crammed down plans contained an operation scheme which met with US the feasibility test.⁴⁸⁰ In the four crammed down plans, only the plan of Dixian stated what business it would do in order to improve its operation. Moreover, only the plan of Jinhua disclosed who would be the new financier and the other three plans just stated that the debtor would try to find a new financier. In addition, none of the four plans talked about the adequacy of the debtor's capital and the expected earning ability of the debtor.⁴⁸¹ Therefore, the empirical study shows that some Chinese courts have failed to apply a strict standard to check whether a plan meets with the feasibility test. Since China does not have a case law system, in order to help the court to apply a general feasibility test in the way that is expected by the legislators, it is necessary to provide in the bankruptcy law standards that are as detailed as possible concerning the application of the general

⁴⁷⁴ The five plans were the plans of the following 5 cases: Beiya, Qinling, Xiabin, Danhua, Haina.

⁴⁷⁵ The plan of Xiabin.

⁴⁷⁶ The plan of Beiya, Qinling, Xintai, Jinhua, Shentai. The plan of Jinhua and Shentai said that the debtor would continue its old business and that the reorganizer would help the debtor to explore new projects, but did not say what the new business would be.

⁴⁷⁷ See Appendix C.

⁴⁷⁸ See Appendix C.

⁴⁷⁹ Although a feasibility test is provided in the EBL as a test for cram-down plans, the author explored whether there is a feasible scheme in both consensual plans and non-consensual plans because the feasibility test is provided as a test for all the confirmed plans in the US and it is useful to explore whether the EBL consensual plans contain feasible schemes from the perspective of comparative study.

⁴⁸⁰ The four cases are the case of Baoshuo, Jinhua, Guangming, and Dixian. See Appendix B for the voting result.

⁴⁸¹ See Appendix C.

standard.

(3) Problems in the provisions on cram-down requirements

With respect to the overall cram down requirement, the EBL's provisions have a series of defects. The cram-down requirements in the EBL may be summarized as such: full payment plus delay compensation to a dissenting class of secured claims; full payment to a dissenting class of tax claims and employment claims; a payment ratio no lower than liquidation payment ratio for a dissenting class of general unsecured claims; a fair and equitable adjustment of the interests of a dissenting class of shareholders; fair treatment of members of one class and no violation of the priority order among unsecured claims specified in Article 113; deployment scheme being feasible.⁴⁸² Compared with Chapter 11's provisions on cram-down requirements, the EBL's provisions on cram-down requirements are problematic.

Unlike Chapter 11, the EBL does not contain the general requirements, i.e. the "non-discrimination-test" and "fair-and-equitable-test". The non-discrimination test, which is a cram-down requirement applying to the treatment of all dissenting classes under Chapter 11, is used for preventing all kinds of discrimination to a dissenting class in Chapter 11 cases. In contrast, in the EBL it is just a device for preventing discrimination within one class. The fair-and-equitable test, which is a cram-down requirement applying to the treatment of all dissenting classes under Chapter 11, is used by the EBL only for testing the treatment of a dissenting class of shareholders. The limited scope of application of the non-discrimination-test and fair-and-equitable-test implies that the dissenting classes in an EBL case do not enjoy the comprehensive protection provided by these general rules. For instance, in a hypothetical EBL case, a dissenting class of general unsecured creditors, considers that the discount rate for the delayed payment is too low and that they receive less than full payment, while shareholders receive some distribution. This class does not have any weapon with which it can object to the court's cram-down confirmation, if they receive more than they would receive under a hypothetical liquidation. However, if it would have been a Chapter 11 case, the dissenting class of unsecured creditors might have referred to the non-discrimination test by claiming that they bear higher risk than secured creditors and that the plan uses a discount rate which is at least equal to the one used for valuing the claims of

⁴⁸² The EBL, Art. 87. Please refer to Section 4.2.2.1 for the content of Article 113.

secured creditors. Moreover, the dissenting class of unsecured creditors might have referred to the fair-and-equitable test by claiming that shareholders receive a distribution before they receive full payment.

In addition, what deserves serious attention is that the core content of the fair-and-equitable test under Chapter 11, i.e. the absolute priority rule, is missing in the EBL cram-down requirements. The problems caused by lack of provision on the absolute priority rule are discussed in detail below.

(4) Incomplete provision on the absolute priority rule

In answer to the question of whether the EBL contains a provision on the absolute priority rule, different opinions arise within the Chinese bankruptcy academia. Some scholars comment that the absolute priority rule is provided in item (1), (2), (5) of paragraph two of Article 87,⁴⁸³ while some scholar conclude that the EBL fails to provide the absolute priority rule.⁴⁸⁴ Do item (1), (2), (5) of paragraph two of Article 87 provide the absolute priority rule? We should carefully examine the three items one by one. Item (1) provides the requirement on the treatment of the class of secured creditors. If the absolute priority rule is considered as a general principle that is “to ensure that creditors in bankruptcy are paid according to their nonbankruptcy priorities,”⁴⁸⁵ this reflects part of the absolute priority rule. Item (2) provides that the plan should provide full payment to a dissenting class of employment claims and tax claims, while item (5) provides that the payment does not violate the priority order provided in Article 113, a provision that defined the priority order among unsecured claims.⁴⁸⁶ To conclude, item (1), (2), (5) of paragraph two of Article 87 fail to provide the absolute priority rule in a complete way since an important content of the absolute priority rule, which is that the unsecured creditors and shareholders should be paid according to their nonbankruptcy priorities, is missing.

⁴⁸³ 王欣新、徐阳光 (Xinxing Wang & Yangguang Xu), 《破产重整立法若干问题研究》(Study on Several Bankruptcy Reorganization Legislative Issues), 载《政治与法律》(Politics and Law), 2007 年第 1 期, 第 93 页。(issue 1 of 2007, p. 93)

⁴⁸⁴ 李志强 (Zhiqiang Li), 《关于我国破产重整计划批准制度的思考—以债权人利益保护为中心》, (Thoughts on our bankruptcy reorganization plan confirmation system—from the perspective of the protection of creditors’ interest)载《北方法学》, (North Law Journal), 2008 年第 3 期第 54-55 页 (Issue 3 of 2008, pp. 54-55).

⁴⁸⁵ Douglas G. Baird, *ELEMENTS OF BANKRUPTCY*, Foundation Press, 4th edition, 24 (2006). See Section 4.1.2.1 for the detailed discussion of the implication of the absolute priority rule.

⁴⁸⁶ Please refer to Section 4.2.2.1 for the content of Article 113 of the EBL.

In order to get a complete answer, we need to further examine the other cram down requirements contained in the other items in paragraph two of Article 87. Item (2) which requires that the payment ratio of unsecured claims should not be lower than that under a hypothetical liquidation does not touch upon the priority order among unsecured creditors and shareholders. Item (4), which provides that the adjustment of the interest of shareholders should be fair and equitable, is quite ambiguous. While the standard for judging whether the treatment of shareholders is fair and equitable is clear under Chapter 11 because of the absolute priority rule, it is unclear under the EBL. For instance, assume in an EBL case XX, the ratio of payment to general unsecured claims under a hypothetical liquidation is 20%. Is a non-consensual plan that provides general unsecured creditors 30% payment of their claims and leaves the remains to the shareholders fair and equitable to the shareholders? In this case, general unsecured creditors may insist on receiving 100% payment of their claims before shareholders receive any distribution while shareholders may insist on paying general unsecured creditors 20% payment of their claims and keeping all the remains for shareholders. Since the EBL only mandates a payment ratio for general unsecured creditors that is no less than that under a hypothetical liquidation, one cannot get a clear answer to the question of which kind of treatment is fair and equitable to shareholders in this case. Item (4) may be considered as narrowly touching upon the absolute priority rule, if the court interprets this to mean that item (4) requires that classes superior to the dissenting class of shareholders should not receive more than full payment. However, without a clear statutory provision, the court may interpret item (4) in different ways.⁴⁸⁷ Recall that the complete content of the absolute priority rule is that a dissenting senior class must receive full payment before classes junior to it receive anything; classes senior to the dissenting class should not receive more than full payment.⁴⁸⁸ To conclude, the EBL fails to provide the absolute priority rule in a complete and clear way.

Recall that the absolute priority rule is an important doctrine under Chapter 11, which helps to ensure a fair and equitable distribution of the debtor's value among the unsecured creditors

⁴⁸⁷ Facing a case XX, a court may hold that 20%, 30%, or 100% payment to the class of general unsecured creditors is fair and equitable to the class of shareholders, since the EBL only mandates the payment ratio should not be less than that under liquidation, which is 20% in case XX.

⁴⁸⁸ See Section 4.1.2.1 for the implication of the absolute priority rule.

and shareholders and sets the right decision-making incentives in using the bankruptcy reorganization.⁴⁸⁹ The EBL's failure in providing the absolute priority rule in a complete way may lead to an unfair distribution model in both consensual plans and cram down plans which may further cause distorted use of the reorganization procedure. A detailed analysis is below.

The lack of a complete provision on the absolute priority rule leads to an inefficient distribution model with respect to cram-down plans. In the 18 cases studied by the author, 4 cases ended with a cram-down plan, Baoshuo, Jinhua, Guangming, and Dixian. In these four cases, the percentage of shares of the reorganized debtor distributed to the old shareholder was 69%, 70%, 92%, 100% respectively, while the class of general unsecured claims received partial payment.⁴⁹⁰ Based on the disclosed information, the author was able to approximately calculate the overall ratio of payment to general unsecured claims in the case of Baoshuo, which was about 13.08%.⁴⁹¹ In contrast to the low payment ratio of general unsecured claims, the old shareholders in the case of Baoshuo held a high percentage of the shares of the reorganized debtor, which was 69%. The plan of Baoshuo was crammed down over the objection of the class of general unsecured claims.⁴⁹² Is it efficient to leave a substantial percentage of the reorganized debtor's shares to the old shareholders while unsecured creditors are partially paid? According to the creditors' bargain theory, the absolute priority rule is efficient in that it respects the pre-bankruptcy priority order, avoids wealth redistribution, sets up a fair and equitable distribution model, aligns cost-bearing with benefits-sharing, sets the right incentives in reorganization bargaining and prevents a distorted use of the reorganization procedures.⁴⁹³ The EBL, because of its defective provision on the

⁴⁸⁹ See Section 4.1.2.5 for detailed discussions on the efficient elements of the absolute priority rule.

⁴⁹⁰ See Appendix B.

⁴⁹¹ See Appendix B. The ratio of general unsecured claims paid by shares was not calculated in the plan. According to the Public Notice No. 2008-016, on February 5, the court made a cram-down confirmation over the reorganization plan. According to the public Notice No. 2008-019, on February 25, 2008, the public auction of 45,130,937 shares held by the biggest shareholder was conducted and the highest bid price was RMB 23,500,000, which implied the price per share in the auction was RMB 0.52. According to the Public Notice No. 2008-002, the total unsecured claims were RMB 4,652,888,753.28. According to Public Notice No. 2008-042, 7,310,731 shares were used to pay unsecured claims. Based on the price in the public auction, the value of the shares paid to the class of unsecured claims was RMB the share-payment ratio was about 0.08%. Taking into consideration of the 13% paid by cash, the total payment ratio was about 13.08%. Because the information disclosed in the other three cases are very insufficient, the author can not calculate the overall ratio of payment to general unsecured claims in the other three cases.

⁴⁹² See Public Notice No. 2008-011 made by Hebei Baoshuo Co., Ltd.

⁴⁹³ See Section 4.1.2.5 for the efficient elements of the absolute priority rule.

absolute priority rule, fails to respect the non-bankruptcy priority order and may have a negative effect on the interested parties' bargaining and cause wealth redistribution which leads to distorted incentives of interested parties when they decide whether to use the reorganization procedure.⁴⁹⁴

The effect of the EBL's defective provisions on the absolute priority rule over the interested parties' bargaining is reflected in the content of consensual plans. As the interested parties bargain in the shadow of the cram-down requirements, the EBL's defective provisions on the absolute priority rule leads to an inefficient distribution in consensual plans.⁴⁹⁵ The absolute priority rule sets the bargaining leverage of unsecured creditors and shareholders. Under Chapter 11, because of the absolute priority rule, it is unsecured creditors that decide whether they would like to abandon part of the wealth to the shareholders, since the absolute priority clearly specifies that the debtor's value should be first used to pay unsecured creditors in full before shareholders are to receive anything. However, under the EBL, after paying unsecured creditors what they would receive under liquidation, how much additional value a plan may provide to the unsecured creditors depends on how generous the shareholders are. Taking into consideration that the bargaining delay is costly to creditors, general unsecured creditors, knowing that they can only be guaranteed to receive what they would receive under liquidation even if they enter into the cram-down procedure, may be forced to choose to support a plan which provides a payment only a little bit higher than what they would receive under liquidation. In 14 cases, among the 18 cases that were studied, the interested parties reached a consensual plan in which the average ratio of the shares of the reorganized debtor being held by the old shareholder was either clearly stated, or could be calculated based on the relevant information. The average ratio of the shares of the reorganized debtor being held by the old shareholder was 80%.⁴⁹⁶ Although a consensual plan was reached in 14 cases, only in 8 cases did the plan state the overall payment ratio to the class of general unsecured claims and the average ratio of payment was 35%.⁴⁹⁷ The high percentage of consensual plans and

⁴⁹⁴ See Section 2.1.1.2. for the discussion of wealth redistribution and bankruptcy forum shopping.

⁴⁹⁵ Kenneth N. Klee, 'All You Ever Wanted to Know about Cram Down under the New Bankruptcy Code' (1979) 53 Am. Bankr. L. J. 133, p. 134.

⁴⁹⁶ In 14 of the 18 cases, a consensual plan was reached. See Appendix B for the distribution in the cases that ended with a consensual plan.

⁴⁹⁷ The 8 cases are Hualong, Huayuan, Beiya, Qinling, Shentai, Pianzhuan, Haina, Xingmei. Please see

the comparatively low percentage of payment to unsecured creditors while the old shareholders retained a high percentage of the shares of the reorganized debtor reflect the effect of the EBL's defective provisions on absolute priority rule over the interested parties' bargaining and the wealth distribution in consensual plans.

The analysis reveals that due to the incomplete provisions on the absolute priority rule, the EBL establishes a wealth redistribution model which favors shareholders, while putting unsecured creditors at a disadvantaged position. The lack of a complete provision on the absolute priority rule and the inefficient distribution model may lead to a distorted use of the reorganization procedure, i.e. using bankruptcy reorganization as a legal device for getting rid of unsecured claims. Under the EBL's cram-down provision, because of the lack of provisions on the central content of the absolute priority rule, it seems that the more insolvent a debtor is, the better is the old shareholders' position in receiving wealth distribution, since the baseline standard for the payment to unsecured creditors is what they would receive under liquidation. If the debtor has got an efficient reorganization plan, the old shareholders might first deepen insolvency and then enter into reorganization, reap most of the reorganization profits and get rid of the general unsecured creditors by paying a low percentage of their claims which is equal to or a little bit higher than what they would receive under liquidation. Thus, bankruptcy reorganization can be used by the debtor and its shareholders as a device of "legally" eliminating general unsecured claims and magically turning the unprofitable companies into profitable ones. Some bankruptcy professionals have noticed the vulnerable position of creditors and the emerging sign of the abuse of the reorganization procedure.⁴⁹⁸

4.2.2.4 Reform Suggestions for the Chinese Plan-passing System

Based on the discussion above, the following reform suggestions are proposed so that the

Appendix B. The plan in the other 10 cases did not state the payment ratio of general unsecured claims and the author can not calculate the ratio based on the limited information.

⁴⁹⁸ See e.g. 汤晓明(Xiaoming Tang), 《从破产重整制度看银行债权的保护》(Examining the Protection of Bank Claims from the Perspective of Bankruptcy reorganization procedure), Available at: <http://www.cnstock.com/index/gdbb/201006/588712.htm> (visited June 19, 2010); 郑重 (Zhong Zheng), 《政府主导*ST 九发破产重整 债权银行成“待宰羔羊”》(Government Dominating the Bankruptcy Reorganization of *ST Jiufa Creditor banks Becoming Goats to Be Killed), 中国时报(China Times), Page 010 of November 1, 2008; 俞坚(Jian Yu), 《“策划”*ST 宏盛破产重整 舜东投资疑似“项目公司”》(“Planning” the Bankruptcy Reorganization of *ST Shunsheng Shundong Investment Suspected to Be “Project Corporation”), 上海证券报(Shanghai Securities daily), Page F08 of February 10, 2010.

EBL's plan-passing system may provide clear guidance to the bargaining parties in designing an efficient plan, realize a powerful screening of the quality of the plans and ensure that the confirmed plan produced at the end of a reorganization procedure is a plan that maximizes the debtor's value and distributes that value efficiently.

4.2.2.5 Reform suggestion for the classified voting system

(1) Reform suggestion for classification

It is suggested that the EBL should provide that claims and interests that are substantially similar should be put into one class. Secured claims that are secured by the same collateral with the same priority level and that should be paid pro rata by the value of the collateral in the case of default should be considered as being substantially similar and should be put into one class. Unsecured claims and shareholders' interests that enjoy the same priority level in receiving payment according to the priority order set up by the pre-bankruptcy contracts, non-bankruptcy law, and the bankruptcy liquidation provisions, should be considered as substantially similar and be put into one voting class. A detailed analysis of the reform suggestion is below.

Under Chapter 11, the debtor is allowed to freely mold the classification according to the specific circumstances of a case, since Chapter 11 only requires that the claims or interests being put in one class should be substantially similar and does not mandate that claims and interests that are substantially similar be put into one class. Chapter 11's flexible classification system causes the problem of gerrymandering.⁴⁹⁹ To avoid the problem of gerrymandering, it is suggested that the EBL mandates that claims or interests that are substantially similar should be put into one class.

What factors are determinative in judging whether the claims or interests are "substantially similar"? A common recognition is that the nature of a secured claim is mainly determined by the character of the security that guarantees the payment of a secured claim and that the nature of unsecured claims and shareholder' claims is mainly determined by their priority level.⁵⁰⁰ Thus, the author suggests that secured claims, which are secured by the same

⁴⁹⁹ See Section 4.1.1.3.

⁵⁰⁰ "Creditors who have liens or security interests in property of the debtor are entitled to preferential treatment by virtue of their security interests. Others ranked in order of priority in accordance with the

collateral with the same priority level, should be put into one class. How can the priority level of all the unsecured claims and shareholders' interests be calculated for the purpose of classification? The priority level of all the claims and interests is defined by the pre-bankruptcy contracts among the interested parties and non-bankruptcy law and is clearly illustrated in the liquidation provisions. The pre-bankruptcy priority order, which is originally defined explicitly or implicitly by the interested parties' pre-bankruptcy contracts and non-bankruptcy law, is summarized and expressed as a whole by the priority order provided in the liquidation procedure because the liquidation procedure is a procedure for selling the debtor's assets and distributing the proceeds according to a clear and complete list of all kinds of claims drawn up in order of priority. Compared with the liquidation procedure, the reorganization procedure is more complicated in that it involves a complicated process for making the most efficient deployment decision. Where a consensual plan is reached, the priority order is defined in the consensual plan through bargaining. Where the interested parties fail to reach a consensual plan, how the debtor's value should be distributed to the dissenting classes is a problem that needs to be solved by the law. The absolute priority rule is a device employed by US law to solve this problem. The spirit of the absolute priority rule is to keep the priority order in the reorganization procedure in line with the liquidation and non-bankruptcy priority order.⁵⁰¹ To conclude, the priority order applied during the liquidation procedure can be used as a standard for setting the priority level of claims or interests for the purpose of classification. Where the liquidation priority order is not complete, the court has to refer to the pre-bankruptcy contract and non-bankruptcy law for determining the priority level of a specific claim. Therefore, the author suggests that, with respect to the classification of unsecured claims and shareholders' interests, the EBL may specify that: unsecured claims and shareholders' interests that enjoy the same priority level in receiving payment as that set up in pre-bankruptcy contracts, non-bankruptcy law, and the bankruptcy liquidation provisions, should be considered as substantially similar and be put into one voting class. For instance, general unsecured claims should be put into one class, while

rules of bankruptcy law and their rights under prevailing nonbankruptcy law.” Brian A. Blum (2006), *Bankruptcy and Debtor/Creditor: Examples and Explanations*, Aspen Publishers, 4th Ed. , p. 99. The House Report states that secured creditors, by nature, are most often in single-member class. House Report, p. 6195.

⁵⁰¹ Douglas G. Baird, *ELEMENTS OF BANKRUPTCY*, Foundation Press, 4th edition, 24 (2006).

subordinated general unsecured claims should be put into another class. Similarly, preferred shareholders' interests and common shareholders' interests should be put into different classes.

According to the creditors' bargain theory, bankruptcy law should respect the interested parties' non-bankruptcy entitlements and try to establish a collective procedure that maximizes the debtor's overall value and minimizes the debt-collection costs.⁵⁰² The reform suggestion is efficient in that it respects the interested parties' non-bankruptcy entitlements, helps to achieve "equal treatment to same claims" (interested parties with substantially similar non-bankruptcy entitlements receive equal treatment), and limits forum shopping and strategic behaviors. Compared with Chapter 11's classification system, the proposed classification system leaves no room for the plan proponent to freely mold classification and avoids the costs caused by the bargaining and litigation over proper classification and the gerrymandering problem.

(2) Reform suggestion for shareholders' voting right

As discussed above, whether a plan distributes the shares of the reorganized debtor to the creditors or not, it affects shareholders' interests. Only if shareholders are given voting rights, will they have the opportunity to participate in the bargaining with regard to the content of the plan. Since the EBL has adopted the method of allowing the interested bargaining to reach a solution through bargaining and since it is unclear on the commencement of the bargaining what the most efficient method for deploying the debtor's assets is, how much the debtor's value is or how the value should be distributed, the shareholders should not be excluded from the bargaining. Thus, it is suggested that shareholders always be given the right to vote on the plan in order to ensure the bargaining is not manipulated by the creditors, shareholders' opinions are fully expressed and their interests are equally protected.

(3) Reform suggestion for the majority voting rule

The optimal majority requirement is the best tradeoff between minority protection and hold up minimization.⁵⁰³ As discussed in Section 4.1.1.4, compared to the simple majority rule, the supermajority rule does not have an obvious strength in enhancing minority protection and

⁵⁰² See Section 2.1.1.1 and 2.1.1.2.

⁵⁰³ Holden, Richard, Supermajority Voting Rules (June 2004). Available at SSRN: <http://ssrn.com/abstract=625122> or doi:10.2139/ssrn.625122, pp. 2-3.

increasing the probability of a correct decision. Moreover, in bankruptcy reorganization, the dissenting minority of an assenting class can be protected by the best-interest-test. Therefore, the author proposes the replacement of the supermajority rule by the simple majority rule.

4.2.2.6 Reform Suggestions for the Confirmation system

First, the EBL should add some general confirmation requirements to ensure that the reorganization plan is economically efficient and contains a feasible deployment scheme, the reorganized debtor has a capable management team, the debtor's managers' receive reasonable remuneration during the reorganization period, the expenses incurred during the reorganization period are reasonable, the reorganization procedure is not used for improper purpose, the plan is proposed in good faith and in conformity with all the application laws. It is suggested that the following detailed description of the general confirmation requirements be inserted in Article 86 as a final paragraph to this article:

“For the purpose of confirmation, a plan, no matter whether it has been accepted by all the voting classes or not, shall at least meet with the following requirements:

- (1) All the dissenting holders of claims or interests shall be paid an amount that is not less than the amount they would receive under liquidation, regardless of whether or not the class to which they belong accepts the plan ;
- (2) A feasible reorganization scheme of the debtor's business shall be established; in examining the feasibility of the reorganization scheme, the court may consider factors, such as: (i) the debtor's prior performance, (ii) the adequacy of the debtor's capital structure, (iii) the earning power of the business, (iv) economic conditions, (v) the ability of the management and the probability of the same management continuing, and (vi) any other matter that may affect the debtor's ability to execute the plan,⁵⁰⁴
- (3) The interested parties shall be adequately informed regarding the identity and affiliations of the top managers and insiders of the reorganized debtor and the other corporations that will participate in the rehabilitation project, the affiliations and remuneration of the top managers and insiders of the debtor that will be employed in the

⁵⁰⁴ This guidance is borrowed from US case law. Since China does not have a case law system, it is better to make the statutory provision as detailed as possible so as to provide a clear but non-exclusive guidance to the court in applying a general requirement, such as the feasibility test.

reorganized debtor and their compensation and any other information that is necessary for the interested parties to make an informed judgment of the future management of the debtor and the feasibility of the plan;

- (4) The interested parties shall be adequately informed regarding any court fees, professional service fees and other expenses relevant to the reorganization case;
- (5) The reorganization petition shall be filed in good faith; the plan shall be proposed in good faith and shall comply with any applicable bankruptcy and non-bankruptcy law.”

Second, in the context of cram down, it is important to provide comprehensive protection to the dissenting classes by adopting the fair-and-equitable test and the non-discrimination test, the absolute priority rule in particular, which is a material device for achieving fair and equitable distribution to the dissenting classes. Thus, the author suggests that the following cram-down requirements should be inserted into Paragraph two of Article 87 of the EBL:

The plan shall arrange fair and equal treatment to a dissenting class and does not unfairly discriminate a dissenting class. In order to guarantee such fair and equal treatment to a dissenting class of unsecured claims or shareholder’s interests a plan should ensure that no classes senior to the dissenting class receives more than full payment in terms of present value under the plan and no classes junior to the dissenting class receive any payment before the dissenting class receives full payment in terms of present value. For the purpose of examining the present value of the distribution, where the payment is made in debtor’s shares, an objective, reasonable and convincing valuation report on the debtor’s reorganization value shall be attached.⁵⁰⁵ With respect to a class of priority shareholders’ interests, full payment shall be the greatest of any liquidation amount or redemption price to which the shareholders are entitled.

Third, in bankruptcy reorganization, valuation is a fundamental problem.⁵⁰⁶ In the stage of confirmation, a series of valuations must be conducted, which may include calculating the debtor’s reorganization value and liquidation value, the value of the collateral, the present value of the payment to the dissenting members of a consenting class, the present value of the payment to a dissenting class of secured creditors, unsecured creditors, preferred shareholders

⁵⁰⁵ The detailed standards for the sustainable valuation report, such as the proper valuation method and valuation content, are beyond the scope of this thesis.

⁵⁰⁶ See 4.1.1.3 and 4.1.2.4 for a detailed discussion.

for the purpose of applying the best-interest-test and the absolute priority rule. Although valuation is uncertain, it is better to have a set of valuation rules that are as detailed as possible in order to limit the valuation mistakes and achieve a stable and reasonable valuation result. The US practice has suggested that there can be many controversial ideas and practices with respect to the valuation method of the debtor, the valuation of the collateral, the relationship between the valuation of the collateral for the purpose of adequate protection and plan-confirmation. With respect to valuation uncertainty, the Chinese legislative authority can draw useful lessons from the US practice and establish a team consisting of valuation specialists, bankruptcy lawyers and judges with an aim of producing a set of deliberately designed valuation rules.⁵⁰⁷ Despite the fact that valuation can never be certain and accurate, it is better to establish a set of valuation rules than have no rules at all. A set of deliberately designed rules will help the debtor, the plan proponent and the bankruptcy judges to achieve the most reasonable, clear, objective and consistent valuation result that can be achieved in our practical world and this valuation result may help the bargaining parties and the bankruptcy judge to make an informed judgment of the draft plan.⁵⁰⁸

⁵⁰⁷ Designing detailed valuation rules needs professional financial knowledge and is beyond the scope of this thesis.

⁵⁰⁸ Valuation is also involved during the plan-drafting process for the purpose of determining the adequate protection of the secured creditors' interest. This reform suggestion on valuation applies to the valuations involved in the whole reorganization procedure. Since it is discussed here, it will not be repeated again in Chapter 5 of the book.